S. Hrg. 99-93

ADJUSTABLE RATE MORTGAGES

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER AFFAIRS

AND THE

SUBCOMMITTEE ON
HOUSING AND URBAN AFFAIRS

OF THE

COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ON

ADJUSTABLE RATE MORTGAGES OFFERED AT RATES BELOW MARKET RATES THAT STUN BORROWERS WITH "PAYMENT SHOCK" WHEN THE INITIAL RATES EXPIRE AND THEY DISCOVER THAT IN SOME CASES THE OUTSTANDING PRINCIPAL IS LARGER THAN WHAT THEY HAD BEGUN. THIS PRESENTS THE INDUSTRY WITH THE POTENTIAL FOR HIGH DEFAULT RATES IN FUTURE YEARS

APRIL 19, 1985

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE
48-516 O WASHINGTON : 1985

S241-14

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ADJUSTABLE RATE MORTGAGES

FRIDAY, APRIL 19, 1985

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, JOINT HEARING WITH THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER AFFAIRS AND THE SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS,

Washington, DC.

The subcommittee met at 9 a.m. in room SD-538, Dirksen Senate Office Building, Senator Gorton (chairman of the subcommittee) presiding.

Present: Senators Gorton, D'Amato, Mattingly, Proxmire, Cranston, Dodd, and Riegle.

OPENING STATEMENT OF SENATOR GORTON

Senator GORTON. Before we begin this meeting, I am able to announce that the chairman has just landed. [Applause.]

And we trust that he will be back at work, as great a comedown as that is, relatively quickly.

This is a joint hearing of the Subcommittee on Financial Institutions and Consumer Affairs and the Subcommittee on Housing and Urban Affairs, for the purpose of examining the role of the adjustable rate mortgages in the housing market.

The purpose of this hearing is oversight. There is no legislation now pending on that subject of adjustable rate mortgages. Proposals on that subject have a way of arising quickly, however. It is appropriate that the committee take this opportunity to assure itself that it has adequately aired the issues surrounding adjustable rate mortgages [ARM's]. There can be no doubt that the ability of home lenders to offer ARM's has been and will continue to be an absolutely vital element in permitting the industry better to match the terms of its assets and liabilities.

In addition, the availability of adjustable rate mortgages has permitted many home buyers to qualify for home loans, when they would have been shut out of the market, when only conventional instruments were available. But the development of ARM's has not been without problems. Loans offered at initial rates far below market rates often stunned borrowers not only with payment shock when the initial favorable rates expire but also with the unhappy realization that in some cases they had paid on a loan for 1 year, only to discover that the outstanding principal is larger than what they had begun.

The making of such teaser loans is not only a classic example of misleading the consumers but also presents the industry with the potential for high default rates in future years.

Fortunately, there appears to have been some progress in eliminating what appears to be a gross abuse in the marketplace. Regulatory agencies and private trade associations conducted a consumer education campaign culminating in the recent consumer handbook, for which they are to be complimented. Nevertheless, I am still troubled with the frequency with which ARM's continue to be offered at initial rates far below the so-called fully indexed rates, that is below the rates which would exist if the full spread of the index rate would be put in place from day one. Such initial discounts would appear to be far more prevalent on adjustable rate loans than on fixed rate loans, although the worst abuse of negative amortization need not be present in these loans. Still, not every purchaser is aware of the fact that his or her mortgage rates will go up at the end of the initial period, even if interest rates in general have not risen.

I am also concerned that mortgage makers and insurers take full stock of the differences between fixed and adjustable rate mortgages when deciding whether a buyer qualifies for such a loan. It seems difficult to rationalize, using the same qualifying standards for two different types of loans.

I want to thank the witnesses for coming here today and I look forward to hearing their testimony on these issues.

I wish to repeat the message that I know staff conveyed earlier. I am going to ask you to keep your oral statements to 10 minutes. This will give us more time for questioning. Your full statements will, of course, be a part of the record.

At this point, we will start with Shannon Fairbanks.

STATEMENT OF SHANNON FAIRBANKS, CHIEF OF STAFF AND EXECUTIVE STAFF DIRECTOR, FEDERAL HOME LOAN BANK BOARD

Ms. **Fairbanks**. Thank you very much. Good morning, Mr. Chairman and members of the committee. I am delighted to appear before you this morning. May I just parenthetically note that you are in for a good period of testimony, because the witnesses this morning have promised to restrict their remarks to 5 minutes.

I am going to summarize my remarks, and I have submitted complete testimony of the record.

Senator **Gorton**. It will be included.

LAW OF LAND IS DEREGULATION

Ms. **Fairbanks**. Today the law of the land is deregulation. Adjustable rate lending is the clear, inevitable result. Either lenders must tie their lending rates to the fluctuating cost of money, using ARM's, or there will be no lenders to make loans. In 1984, the proportion of ARM's being made by savings institutions skyrocketed to roughly two ARM's for every fixed rate mortgage. Despite a recent decline, the proportion remains above 50 percent. From a broad perspective, ARM's have contributed more than any other single factor toward the recovery of the Nation's housing economy by promoting a strong and sustained housing sector.

But as ARM's grow in importance, we at Federal Home Loan Bank Board have focused closely on the problems our institutions and their customers face in today's radically deregulated, rate fluctuating, liability environment. As a threshold matter, the customer must be given adequate information. Under our current regulations adopted in 1983, federally chartered associations, offering ARM's, must disclose the term of the loan or the way it will be established, the initial interest rate or the way it will be calculated, the amount of the initial payment and how it is determined and full explanation of how adjustments will be made.

To promote more standardized disclosure, the Bank Board has proposed that the "Consumer Handbook on Adjustable Rate Mortgages," developed jointly by the Bank Board and the Federal Reserve Board, be provided to customers of federally insured institutions prior to the acceptance of a mortgage application.

Let me repeat that. We are mandating now that this booklet be given to consumers before they make their application for a loan. Our proposed regulation mandating this has just gone out for a 60-day comment period. The ARM's handbook takes the mystery out of ARM's and gives borrowers one of their most important safeguards, the right questions to ask. The booklet was issued jointly in the first week of 1985 by both the Bank Board and the Federal Reserve Board. It was developed in direct response to a congressional request and received the endorsement of more than 25 diverse organizations, including the Consumer Federation of America and the U.S. League of Savings Institutions.

As of this date, the first printing of 2.5 million copies is almost completely distributed and the U.S. League, the National Council, and the Mortgage Bankers Association have obtained the printing plates for the booklet, so they can continue to reproduce it for their members.

CLOSER SUPERVISION

To ensure closer supervision of this market, the Bank Board also issued supervisory guidelines in September 1984 through R 61, instructing all FSLIC-insured institutions to underwrite ARM's in an economically reasonable way.

Based on these guidelines, our examiners now scrutinize ARM's underwriting by institutions as part of their regular exam and supervisory action has been taken when institutions have not complied. It is becoming increasingly clear, however, that most ARM's being written today are, in fact, creditworthy ARM's. Surveys show that teasers are disappearing and the spread between first-year ARM's and fixed-rate mortgages increasingly reflect the differences between short- and long-term interest rates rather than promotional pricing.

Survey results also show that 90 percent of ARM's being written currently contain fairly stringent annual payment and interest rate caps, rendering political ferment about payment shock increasingly outdated.

I do not mean to imply that every single ARM in this country will meet standards for a perfect ARM. Millions of new ARM's are made every year, and there are bound to be occasional practices that violate desirable standards, prudence, and public policy. In those instances, we will act. At the same time, we at the Board believe the market today is working extremely well. To put it simply, we believe it is poor public policy to place rigid regulations on the mortgage underwriting process.

Over the last five decades, the Bank Board has managed to avoid explicit regulations governing mortgage underwriting. Underwriting is a discretionary business decision. It does not lend itself well to rigid, uniform standards, which regulation usually entails. I hope we can keep it this way. The upsurge in residential mortgage lending over the last 2 years reflects the continuing basic commitment of the Nation's savings institutions to this Nation's home buyers and their ability to master an evolutionary change by introducing ARM's, which has greatly reinforced the link between savings institutions and the home buyers' ability to secure that critically important dream of home ownership.

Thank you very much.

[The complete prepared statement follows:]

STATEMENT OF
SHANNON FAIRBANKS
CHIEF OF STAFF
AND
EXECUTIVE STAFF DIRECTOR
FEDERAL HOME LOAN BANK BOARD

I am delighted to appear before this Joint Meeting on Adjustable-Rate Mortgages held by the Subcommittee on Financial Institutions and Consumer Affairs and the Subcommittee on Housing and Urban Affairs. At the very outset, I want to point out that savings institutions pioneered the development of the adjustable-rate mortgage (ARM) concept. For some savings institutions, the use of the ARM product goes back to 1975 when ARMs were first authorized for California savings and loan institutions.

As you know, in 1980, the Congress made clear its intention that customers of depository institutions should receive, over a phase-in period, market rates of interest for their savings. By now, the Depository Institutions Deregulation Committee (DIDC) has removed virtually all artificial rate and term constraints from liabilities issued by savings institutions and commercial banks.

This is a far cry from the days of the 1960s and 1970s when, in a highly regulated liability environment, savers were paid below-market rates, which in turn resulted in a subsidy -- indeed an important subsidy -- for mortgage borrowers.

In 1980, with the passage of the Depository Institutions Deregulation Act, when Congress authorized the deregulation of depository institution liabilities, it was anticipated that two results would occur: the cost of money to savings institutions and banks would, in all likelihood; rise, and the saver, who had formerly susidized America's mortgage borrowers, would finally get a fair shake, a fair market return on his or her hard-earned funds.

Quite clearly, with this decision the Congress also set in motion events that ultimately would dictate a new kind of mortgage instrument -- an instrument that would have to be tied much more closely to this newly fluctuating cost of money for lending institutions.

No longer would government fiat constrain the rate of interest paid on savings and thus establish the rate on mortgages and other loans sought by borrowers.

Rather, in today's deregulated liability environment, lenders -- savings institutions and banks -- would have little choice in setting rates of interest for borrowers, because the capital marketplace now determines such rates. As a result, either the cost of borrowing would roughly follow the fluctuating cost of money in some acceptable manner, or the lending entity would find itself in deep trouble, or, worse yet, out of business.

To make a long-term, fixed-rate loan using short-term, interest-rate-sensitive monies to fund such lending makes little economic sense in this newly mandated deregulated liability environment. Such mismatched lending practices quickly expose lenders to enormous interest-rate risk -- a lesson the thrift industry has learned very well by now.

If the law of the land is liability deregulation, then adjustable-rate lending is the clear, inevitable result. To be honest, critics of the adjustable-rate mortgage must confront the issues straightforwardly. Either lenders must tie their lending rates to the fluctuating cost of money in some appropriate fashion -- particularly takes into account the borrower's ability to repay -- or there will likely be no lenders to make loans, as the years go on.

Earlier, I pointed out that the savings institution industry pioneered the adjustable-rate mortgage in this country. However, when Chairman Gray and I came to the Board almost two years ago, two fixed-rate mortgages were still being originated for every ARM loan made. During Chairman Gray's first months of office, he took a leadership role in urging the savings institutions' industry to tie lending rates more closely to the fluctuating cost of money, thereby reducing interest-rate risk. In blunt and unambiguous terms he told the industry that the adjustable-rate mortgage was the only real antidote to the deadly financial arsenic represented by the long-term, fixed-rate mortgage being held -- at that time -- in huge amounts on savings institutions' books.

By the fall of 1983, a revolution of earthquake dimensions was occurring. The proportion of ARMs being made monthly by savings institutions had skyrocketed to roughly two ARMs for every fixed-rate mortgage. The tables were turned. This two-to-one ratio of ARMs to fixed-rate mortgages has held fairly steady throughout 1984 and, despite a recent decline, remains above 50 percent. In our view, the relatively rapid shift to ARMs by lenders played a key role in helping the savings institution industry register record mortgage lending volumes in 1983 and 1984. I am sure that from your perspective as overseers of the nation's housing finance system, you will agree the ARM played a principal role in maintaining near-record levels of housing activity in what remains a comparatively high interest-rate environment. From a broad perspective, ARMs have contributed more than perhaps any other single factor towards the recovery of the nation's economy, by promoting a strong and sustained housing recovery.

Single-family housing starts rose from 662,600 in 1982 to 1.079 million in 1984. Some of the increased activity is due to generally lower levels of all interest rates, and some due to the increase in housing affordability associated with ARMs.

As ARMs grow in importance, we at the Federal Home Loan Bank Board have focused closely on both the challenges and the problems savings institutions face in offering this instrument. We have looked candidly and very critically at the abusive practices of a few lenders. However, we do want to applaud those institutions -- those many savings institutions -- that have developed sound ARM products that serve the interests of borrowers and lenders alike in today's radically different, rate-fluctuating, deregulated-liability environment.

We have always maintained that ARMs should balance the advantages and the risks to both lender and borrower. If the ARM is not an attractive investment, thrifts and other investors will not invest. If the ARM places too much of the interest-rate risk on the borrower, the customer will not buy. One example of effective marketplace action was the industry's introduction of payment and interest caps in response to initial customer resistance. Another more recent example is the new, tough ARM standards of the private mortgage insurance industry. Each of these actions has also helped to reduce the potential for customer default due to excessive interest-rate risk.

We believe ARMs continue to offer borrowers several important advantages:

- First, the ARM brings more money into the mortgage market. With the ARM, it is possible to invest in home mortgages without the interest-rate risk of fixed-rate mortgages.
- Second, the ARM can usually be offered at a somewhat lower initial rate, even without a promotional discount, because it does not require the embedded interest-rate risk premium of a fixed-rate mortgage.
- Third, if interest rates decline, the customer can get the benefit of that decline.
- Fourth, customers can shop and negotiate for the combination of features that matches their own economic situation.

It is also obvious that ARMs contain some risks for customers:

- First, the borrower's income may not keep pace with payment increases. Because interest rates have been relatively stable recently, this problem has not surfaced in any substantial way. However, it remains an underlying danger for borrowers.
- Second, negative amortization can become a problem if the borrower needs to sell and the house has not appreciated in value.
- Third, actual payment fluctuations may violate the customer's expectations. Borrowers may underestimate the movement of the index, a problem that frequently surfaces at the time of the first interest rate adjustment. Sometimes, the customer cannot handle the unexpected increase because he or she has not planned for it.

The problem of unanticipated changes may occur for several reasons: communication breakdown, inadequate written disclosure, a poorly drawn or inconsistent contract, or simply sloppy reading by the customer. In most cases, a lender's error is an honest mistake caused by the newness and complexity of the ARMs being administered. In fact, in some instances, the Bank Board has conducted brief on-site examinations to help our institutions identify and correct mistakes. Customers, too, make honest mistakes in reading their documents. For both lenders and borrowers, ARMs represent a new way of doing business.

The Bank Board is well aware of the inherent problems created by inadequate disclosure. Therefore, just as we were in the lead in promoting ARMs, we believe we should be in the lead in promoting adequate ARMs disclosure. We are proud that the Bank Board has required for many years that savings institutions provide the most comprehensive disclosure in the industry for all alternative mortgage instruments.

Under the current regulations, adopted in 1983, for example, federally chartered associations offering ARMs must disclose specific items of information to applicants. The applicant must be told the term of the loan or the way it will be established, the initial interest rate or the way it will be calculated, the amount of the initial payment and how it is determined, a full explanation of how adjustments will be made, including identification of the index, and how the borrower can independently confirm the movement of this index. The disclosures must also show what information will be given the borrower when he is notified of an adjustment, a description of all the circumstances under which the borrower could become obligated to repay the loan before maturity, and if the loan involves a balloon payment, a statement that a large lump-sum payment may become due because the association is not obligated to refinance. These disclosure requirements are the result of the Bank Board's experience with ARMs and represent a refinement of previous requirements, made with the aid of both borrowers and lenders through the notice and comment aspects of the regulatory process.

Improvements in disclosure may alleviate many, but not all, problems. In particular, it is very difficult to overcome the wishful thinking of a family understandably intent on acquiring either an essential roof over their heads or the house of their dreams. We are therefore continuing to study ways to help families make the most realistic financial projections possible.

At this point, however, we would like to highlight and summarize important recent strides that have been made in bringing greater stability and order to ARMs, as well as providing fuller and more standardized disclosure. These steps have been taken to reduce the possibility that ill-informed customers may make ill-advised choices of adjustable-rate mortgages that do not match their economic circumstances.

The Bank Board is extremely pleased at the role that it has been able to play in this area through its influence in both the primary and secondary mortgage markets. The interplay between the primary and secondary market has been extremely important in introducing customer safeguards. Our Board is in a unique position to be able to influence both markets effectively in its dual capacity as the governing body of both the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Bank Board itself.

To promote fuller and more standardized disclosure, the Bank Board has proposed that the Consumer Handbook on Adjustable Rate Mortgages -- which I will discuss shortly -- be provided to customers by FSLIC-insured institutions prior to the acceptance of a mortgage application. Our proposed regulation mandating this has just gone out for a 60-day comment period.

The proposed regulation, if adopted as a final rule, would require that all institutions insured by the FSLIC provide a clear and concise description to individuals seeking ARMs secured by their principal residence or the principal residence of a member of their immediate family. The regulation would specifically recognize the Consumer Handbook as meeting this requirement. This disclosure would be required prior to the prospective borrower filing an application that involves payment of a fee, so that it would be made at a time when all his or her options are open. Although the booklet is directed toward ARMs that are used to purchase a home, the Bank Board would require this disclosure in connection with any loan for which the home is the primary security, including loans secured by junior liens. Disclosure would not be required with respect to loans secured by property that is not the borrower's principal residence or where the property is not the primary security for the loan.

We believe the ARMs handbook is already reaching many of the people who need its basic information. It takes the mystery out of ARMs and gives borrowers one of their most important safeguards: the right questions to ask. The last two pages of the book contain a vital Mortgage Checklist for comparison shopping.

The Bank Board takes pride in the content and distribution of that Consumer Handbook. The booklet was issued jointly the first week of 1985 by the Bank Board and the Federal Reserve Board. It was developed in direct response to a Congressional request by both the Chairman and ranking minority member of the House Committee on Banking, Finance and Urban Affairs, and the Chairman and ranking minority member of the Subcommittee on Housing and Community Development. Agency staffs produced a clear, succinct, balanced booklet that received the endorsement of more than 20 highly diverse organizations, including the Consumer Federation of America, the National Association of Realtors and the U.S. League of Savings Institutions.

As of this date, the first printing of 2-1/2 million copies is almost completely distributed. The Bank Board provided copies to the 12 District Banks within our system for distribution to thrifts, customers, and community organizations. The Board also arranged with the U.S. League of Savings

Institutions to distribute close to one-half million copies to League and Bank System members. The U.S. League and two other organizations -- the National Council of Savings Institutions, and the Mortgage Bankers Association, -- have obtained the printing plates for the booklet, so they can continue to reproduce it for their members. Furthermore, the Consumer Information Center in Pueblo, Colorado, a widely used distributor of Federal publications, will list the ARMs handbook in its next catalog.

During Congressional ARMs hearings last year, there was considerable interest in making consumer information available before the first contact with a lender. Typically, the homebuyer's first contact is a real estate agent. Therefore, the Bank Board staff recently checked with the National Association of Realtors (NAR) and was advised that NAR has distributed one million copies to its members. NAR is now checking with its state affiliates regarding future needs.

We have also taken other timely initiatives to assure ARMs will be safe, viable instruments for borrowers as well as lenders. For instance, about a year ago deep initial discounts, sometimes called "teaser rates," were a source of widespread concern. In February 1984, we told the institutions we supervise that as of March 1, 1984, they had to advertise and disclose discounted ARMs in a clearer and more precise way. This was seven months before other lenders were required to follow -- new advertising and disclosure rules. The Bank Board was the only agency that mandated an early effective date for a Federal Reserve Board interpretation that says that the Annual Percentage Rate, known as the APR, on a "discounted" ARM has to be a composite rate that reflects the fully indexed rate for the life of the loan.

The Bank Board also issued supervisory guidelines in September 1984 (R-Memo-61) instructing all FSLIC-insured institutions to underwrite ARM loans in an economically realistic way and to make sure they identify the precise nature of the caps and the precise index to be used. You may be interested in the passage about underwriting:

> "Another potential problem with discounted ARMs is in underwriting. Interest rate changes may lead to steep increases in payment burdens and subsequent delinquencies if borrowers are originally qualified at the discounted rate with high payment-to-income ratios. The steeper the rate discount, the larger the periodic rate change cap, or the higher the qualifying income ratio, the more likely the possibility of delinquency. It is important that institutions assess a borrower's ability to qualify by measuring current income against the projected adjusted payments which will result from the interest rate change. Lenders should also remember to consider the potential for increase in a borrower's income and compare that figure against anticipated higher payment." (emphasis added)

As I indicated earlier, the Bank Board also plays a very special and important role in the evolution of ARM lending through its role as the Board of Freddie Mac. As a pivotal player in the secondary mortgage market, Freddie Mac plays an essential role in determining the criteria that a mortgage must meet before it becomes securitized.

Kenneth Thygerson, President of Freddie Mac, is appearing before this joint meeting today to describe the initiatives the Bank Board members have pursued in their capacity as the Board for Freddie Mac. Their goal in each instance has been to bring high standards, predictability and standardization to the ARMs market.

There is even more good news about ARMs. In addition to their sheer volume, their favorable effect on housing activity, and their new safeguards, it is becoming increasingly clear that most ARMs being written are, in fact, creditworthy ARMs. Towards the beginning of last year, Congressional critics were claiming that there was a "crisis of ARM quality" and that the ARMs being written contained traps for unwary homebuyers. If there ever was a true crisis of ARM quality -- and I am skeptical -- it evaporated quickly. Survey results from the U.S. League of Savings Institutions, Freddie Mac, the Federal Home Loan Bank of Chicago, and others, show that the market is evolving rapidly towards ARMs that maximize the safety of both homebuyers and home lenders. Surveys show that "teasers" are disappearing quickly. The spread between first year ARMs and fixed-rate mortgage rates increasingly reflects the differences between short - and long-term interest rates, rather than promotional pricing.

Survey results also show that 90 percent of ARMs being written currently contain fairly stringent annual payment and interest rate caps, rendering political ferment about "payment shock" increasingly outdated.

I do not mean to imply that every single ARM in this country will meet standards for a perfect ARM. Millions of new ARMs are made every year, and there are bound to be occasional practices that violate desirable standards of prudence and of public policy. At the same time, we at the Bank Board believe it will be a tremendous mistake to straightjacket a market which, by and large, is working extremely well, in order to deal with a very small percentage of the total loans made.

To put it simply, we believe it is poor public policy to place rigid regulations on the mortgage underwriting process. Over the last five decades, the Bank Board has generally managed to avoid explicit regulations governing mortgage underwriting. Underwriting is a judgmental and discretionary business decision. It does not lend itself well to the rigid, uniform standards that regulations usually entail. I hope we can keep it this way.

We at the Bank Board realize that neither we nor future Boards will be able to maintain a "hands-off" attitude if a growing wave of ARM delinquencies and defaults jeopardize the survival of a large number of savings institutions. Responsible ARM underwriting requires that mortgage lenders scrutinize homebuyers' ability to meet their monthly payments as an ARM evolves over time and not just in an initial month or year. We believe self-regulation accomplishing these results is vital if direct regulation is to be avoided.

Based on the evidence we nave today, default and deliquency ratios on adjustable-rate mortgages that are still in the portfolio of the originator are not significantly different from be in the period when default is likely to occur. Because ofthe low-inflation environment, housing default rates on both ARMs and fixed-rate mortgages are likely to be higher in the next several years than in the late 1970s.

We will certainly continue to monitor these ratios and stay alert to respond if that situation changes. As of now, however, we see no cause for alarm in this aspect, or any other aspect of the ARMs market.

In summary, the upsurge in residential mortgage lending over the last two years reflects the basic commitment of the nation's savings institutions to the nation's homebuyers. It reflects their ability to master an evolutionary change that has greatly reinforced the longstanding connection between savings institutions and housing finance.

Almost three years ago, the President's Commission on Housing concluded that the future of this nation's housing finance system would depend on "the private sector developing new mortgage loan instruments that reduce the initial payment level to borrowers, provide some protection to lenders against future market interest rate increases, have relatively predictable payment schedules and avoid excessive negative amortization." At the time, as the White House staff member to that Commission, I found that statement compelling. Therefore, I am particularly proud to report that the nation's savings institutions have moved decisively in this direction over the last several years. And, I am proud of the role that we at the Bank Board have played in that development.

Thank you very much. I will be glad to entertain questions.

Senator GORTON. Thank you, Ms. Fairbanks. Mr. Maxwell.

STATEMENT OF DAVID O. MAXWELL, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, FEDERAL NATIONAL MORTGAGE ASSOCIATION

Mr. MAXWELL. Thank you, Mr. Chairman, members of the subcommittee. I am David Maxwell, Chairman and Chief Executive Officer of the Federal National Mortgage Association, known as Fannie Mae.

Mr. Chairman, I would like to summarize my prepared testimony and submit my formal statement for the record.

Senator GORTON. It will be included in the record.

Mr. MAXWELL. Thank you, sir.

I want to thank you, Mr. Chairman, and Chairman Hecht and the subcommittees for holding these hearings. The hearings serve a vital educational purpose in highlighting the important role of ARM's in housing American families. As a major purchaser of ARM's, Fannie Mae is naturally concerned that home buyers understand their mortgage obligation. We also want to prevent unsound practices that formerly were followed by some lenders in offering these mortgages, although we believe, as Ms. Fairbanks has just said, that these practices never have and don't now constitute a substantial share of the market.

I would like to cover briefly four points in my oral statement.

INFORM HOME BUYERS

First and most important, again, to echo Ms. Fairbanks, all of us must make sure that home buyers can inform themselves of all the terms and conditions of any ARM mortgage. They have to know the right questions to ask about these new instruments. The purchase of a home is the single most important financial transaction most Americans will enter into in their entire lifetime, and they must know what their real financial obligation is when they agree to future payments on their mortgages that can vary with interest rates. That is why Fannie Mae launched a major national campaign in the spring to educate consumers about ARM's. This campaign followed almost 2 years of substantial efforts by our company to brief lenders, builders, and realtors on these instruments.

The centerpiece of our consumer campaign was our pamphlet, "Fannie Mae's Consumer Guide to ARM's." We distributed thousands of copies. Indeed, a mention of the pamphlet on "Good Morning America" practically broke our phone system. Our pamphlet serves, and we're very proud of this, as the prototype for the "Consumer Handbook on Adjustable Rate Mortgages," which we applaud as an extraordinarily fine job, as published jointly by the Federal Reserve Board and the Federal Home Loan Bank Board.

The simple, easy-to-read style of this booklet should tell home buyers who take the time to read it, what they need to know about adjustable rate mortgages.

ARM'S ARE BENEFICIAL

My second point, and this is one that I wish to emphasize just as much, the ARM mortgage is a beneficial, indeed, an essential instrument to lenders, builders, and home buyers. It is here to stay, and it is our job to make sure that it is serving the needs of these participants in the housing market. For many decades, savings and loan associations, as well as Fannie Mae, invested in long-term fixed rate mortgages and held them in their portfolios.

These subcommittees are painfully aware of what happened in 1981 and 1982, when the short-term interest rates skyrocketed. I think it would be fair to say that thrifts, banks, and indeed, Fannie Mae, would not have suffered so in those years, if their portfolios had held more ARM's. So ARM's gives lenders an essential tool to manage the terms of their assets and liabilities, thus reducing their sensitivity to swings in interest rates.

Moreover, and this is sometimes lost by critics of this program, ARM's are good for all home buyers. While fixed rate mortgages retain an important position in the mortgage marketplace, especially as collateral for mortgage-backed securities, the fact is that ARM's can result in greater availability and lower cost of mortgage money. There are four key reasons for this benefit. First, current borrowers do not have to pay higher rates to compensate lenders for the old low-yielding mortgages in their portfolios.

Second, the lender does not have to factor in a heavy premium to guard against future inflation.

Third, rates are usually lower for short-term money and the ARM is a short-term instrument, so the initial rate can legitimately be lower and qualify more buyers.

Fourth, ARM's will help preserve local lending institutions, the bedrock of our home lending system.

The secondary market in which we are a major player will always be important, but without strong local lenders, the entire mortgage market will be weaker. ARM's will help preserve this vital part of the system.

ARM's today carry interest rates that are very legitimately less than 30-year fixed rate loans, as Ms. Fairbanks has said, and this can qualify many more families to purchase homes.

My third point, which I will touch on very briefly, is that there have been some unsound loans, Mr. Chairman, but we believe these practices were not widespread, and we believe they have disappeared today. I would say that an even higher percentage of ARM's being made today are sound loans that are in the best interests of the consumers, as well as the lenders.

Finally, I want to emphasize to the subcommittees how important the adjustable rate mortgage is to my company.

As you know, we have encountered considerable financial difficulties, and one of the strategies that new management embarked on in 1981 was to restructure the asset side of our portfolio to include more shorter term assets that could be matched against liabilities because of the mismatch that existed prior to that time between short liabilities and long assets. Since that time, we have purchased a large number of adjustable rate mortgages, to the point where at the end of the first quarter of 1985, ARM's constituted almost 14 percent of our entire portfolio from a standing start in 1981.

Our purchases this year to date have been about 31 percent adjustable rate mortgages. This need on our part led us to really play a leadership role in developing adjustable rate mortgages, and that is something that we're extremely proud of, because we also think that that has been a great help to our friends in the savings and loan industry. We feel that we can accept the lower yield we receive on adjustable rate mortgages, as compared to a fixed rate mortgage, because this is a desirable way for us to approach risk reduction. And it is Fannie Mae's objective to reduce the risk of our portfolio, to reduce the risk that we inherited in 1981 in a sound way without any special Government assistance.

Thank you for your attention, Mr. Chairman. I will be happy to answer any questions you may have.

[The complete prepared statement follows:]

Statement of

DAVID O. MAXWELL

CHAIRMAN AND CHIEF EXECUTIVE OFFICER

FANNIE MAE

Before the

SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

AND

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS

AND CONSUMER AFFAIRS

OF THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

April 19, 1985

Executive Summary

Adjustable rate mortgages (ARMs) are the market's response to deregulated liabilities. ARMs developed because mortgage lenders needed interest-sensitive assets to balance the deregulated, interest-rate sensitive liabilities they could attract. Most assets of thrift institutions and other mortgage portfolio investors were 30-year, fixed-rate mortgages. Liabilities were much shorter, with the average life less than four years. Thus, this asset-liability mismatch was a ticking time bomb for mortgage lenders if changes were not made.

Slowly, the federal regulatory agencies -- the Federal Home Loan Bank Board and the Comptroller of the Currency -- realized that they had to permit interest-sensitive assets for the financial institutions under their respective jurisdictions. In 1975, the Bank Board authorized limited adjustment variable rate mortgages (VRMs) for thrifts. The regulators completed the deregulation of ARMs by early 1981.

Homebuyers did not embrace ARMs at first. They were leery of adjustments and their ability to make higher payments.

ARMs became more popular in 1983 for several reasons. First, the spread between ARMs and standard fixed-rate loans widened, making the relative cost of an ARM less expensive. Longer term money became more expensive relative to shorter-term money because of a significantly sloped yield curve. Second, Fannie Mae offered optional consumer safeguards like interest rate and payment caps, which other lenders emulated. Third, some primary market lenders began marketing ARMs aggressively by sacrificing initial interest income. These low initial rates became popular in late 1983 and early 1984.

Unfortunately, a few lenders have given some ARMs a bad name. Using low "teaser" rates as a come-on to uninformed buyers, they promoted ARMs that had the potential for dramatic "payment shock" i.e., increases in monthly mortgage payments far beyond the ability of most homeowners to pay.

This statement emphasizes five points. First, and most important, homebuyers must inform themselves of all of the terms and conditions of any ARM mortgage they are offered. After all, the purchase of a home is the most important single financial transaction most Americans will enter into in their entire lifetimes.

Second, ARMs are a beneficial and essential mortgage instrument -- to lenders, builders, Realtors and homebuyers.

Third, there have been some regrettable ARM practices by a few lenders but they have never been and are not now widespread.

Fourth, Fannie Mae has taken the lead in developing ARMs that help Americans buy and keep homes. Fannie Mae has helped standardize ARMs so buyers, builders, lenders and Realtors could understand them better. And, we have led the move to greater consumer safeguards like interest rate and payment caps. We have put in place several actions to prevent our purchasing any unsound ARMs.

Finally, Fannie Mae launched a major national campaign to educate consumers about ARMs. The centerpiece of our campaign was a pamphlet entitled **"Fannie Mae's Consumer Guide to ARMs."** This campaign followed almost two years of substantial efforts by Fannie Mae to brief lenders, builders and Realtors on these instruments. This pamphlet served as a prototype for the **"Consumer Handbook on Adjustable Rate Mortgages"** published late last year by the Federal Reserve Board and Federal Home Loan Bank Board.

To give the Subcommittees some hard facts about the extent of abusive ARMs now being offered, we conducted a survey of 250 lenders during June of 1984. That survey showed that unsound ARMs are in the minority. Most lenders offer ARMs with interest rate caps or payment caps. And, many lenders limit the amount of negative amortization (where monthly mortgage payments do not meet full interest required) to 125 percent of the original mortgage amount. Few lenders offer "teaser rate" mortgages. Our early findings are supported by recent data published by industry trade groups.

Nonetheless, even if unsound ARMs are rare, they should be corrected. The phrase "a few rotten apples can spoil the barrel" is particularly apt. The many benefits of ARMs to borrowers, lenders, builders and Realtors should not be ignored because some lenders want to book some fast fee income.

These benefits are substantial. They include billions of additional dollars available for mortgages, the qualification of thousands more homebuyers across the country and a way for traditional mortgage lending institutions to assure their long-term health.

To preserve these benefits, Fannie Mae strongly recommends that:

- lenders originate ARMs with reasonable interest rate caps, payment caps or both;
- teaser rate ARMs be eliminated by limiting the initial discount on these loans;

- negative amortization on ARMs be limited to 125 percent of the original mortgage amount;

- Treasury indices be used because they are the most understandable and acceptable to homebuyers;

- the Federal Reserve Board strengthen enforcement of its truth-in-lending regulations (Regulation Z) as well as make a number of changes in its instructions to lenders on calculating the cost of financing (annual percentage rate or APR) an ARM; and

- the Bank Board and the Comptroller of the Currency require more standardized disclosure by the institutions under their respective jurisdictions, including a worst case disclosure to all borrowers.

Adopting these strengthened disclosure requirements should go a long way toward causing the "good" practices we advocate to drive out the "bad" practices of unscrupulous operators.

Finally, though not the specific subject this morning, all of the benefits that ARMs furnish thrift institutions and Fannie Mae because they are shorter-term assets will be lost if the Administration's user fee proposal is adopted. These "taxes" would apply to the Federal Home Loan Banks and Fannie Mae, among others. Speaking for Fannie Mae, we just cannot afford these taxes. Over five years, the tax will swamp our retained earnings. Fannie Mae will be in financial distress if they are imposed, as I testified before this Housing Subcommittee about a month ago.

* * * * *

Messrs. Chairmen and Members of the Subcommittees:

My name is David O. Maxwell. I am the Chairman and Chief Executive Officer of the Federal National Mortgage Association, more commonly known as Fannie Mae. The corporation is exclusively dedicated to supporting residential housing through its secondary mortgage market activities.

I am here today to express Fannie Mae's views on the development of adjustable rate mortgages (ARMs). ARMs are very important to the continued availability of affordable housing. The benefits for borrowers, lenders and mortgage investors are substantial. Potential problems arise from the overly aggressive marketing practices of some, and these practices must be corrected so that ARMs remain a positive advance in housing finance.

I applaud the Subcommittees for conducting this timely review of ARM market developments. These hearings should result in a better understanding of ARMs, culminating in less confusion and more informed use of these loans by homebuyers.

This statement is organized in three parts. First, we review the development of ARMs. This will include the economic rationale, the regulatory framework and the benefits of ARMs to various housing market participants.

Second, we discuss perceived unsound practices in the ARM market, which we believe are confined to a relatively small number of cases, but which are nonetheless important to correct. The extent of these abuses is documented by a survey of nearly 250 lenders that Fannie Mae conducted last June, and which has been supported by recent data published by industry trade groups.

Third, we list Fannie Mae's recommendations for eliminating these abuses and providing potential homebuyers with the information they need to make an informed choice. These recommendations include urging the industry to offer ARMs with reasonable interest rate or payment caps, placing limits on negative amortization, eliminating "teaser" rate loans and providing better disclosure to prospective borrowers.

I. THE PHILOSOPHY AND CHARACTERISTICS OF ADJUSTABLE RATE MORTGAGES: ECONOMIC RATIONALE AND REGULATORY HISTORY

A. Early History and Economic Rationale

ARMs emerged as a nationwide phenomenon in 1983 and are now commonly available throughout the U. S. housing market. However, ARMs are not unprecedented. In fact, only a few foreign countries have long-term, fixed-rate mortgage financing. Canada's experience with roll-over mortgages is the most thoroughly documented and well known.

Variable rate mortgage instruments (VRMs) were first authorized in California in 1971 for state chartered thrift institutions. But, until 1975, VRMs were relatively rare. Most lenders did not offer them, and many buyers had never heard of them. In 1975, California state law was amended to add a number of minimum consumer safeguards to VRMs. These safeguards included a worst-case disclosure, maximum 50 basis points (1/2 percent) interest rate cap in any one year and a lifetime 250 basis points (2 1/2 percent) cap. VRMs gained far wider consumer acceptance with these protections.

A type of VRM -- renegotiated rate mortgages (RRMs) -- was approved in 1979 by the Federal Home Loan Bank Board (FHLBB) for all federally regulated savings and loan associations. RRMs also required worst case disclosure, and had a 1 percent annual cap with a 5 percent lifetime cap.

Even the more liberal terms of the RRM proved not flexible enough given inflationary developments in late 1979 and 1980. Modest interest rate spikes, which the RRM was suited for, became volatile cyclical swings of 500 to 600 basis points in 12-18 months.

In response, in March 1981, the Office of the Comptroller of the Currency (OCC) authorized national banks to offer ARMs. In April 1981, the FHLBB authorized ARMs for federally chartered thrift institutions. The federal regulators' actions were taken to assure the continued availability of mortgage credit by banks and thrifts, as well as their financial health. Congress affirmed those actions and extended them to all lenders under Title VIII of the Garn-St Germain Act.

The development of ARMs was a necessary response to the high rate of inflation experienced since the 1970s and the deregulation of depository institutions' liabilities begun in 1980. ARMs were necessary to assure the survival of mortgage lenders and, thus, a continued supply of affordable mortgage credit. Liability deregulation overwhelmed many lenders, particularly savings and loan associations. Until 1980, savings and loan associations made long-term fixed-rate mortgages (FRMs), held them in their own portfolios, and funded them with short-term deposits that had rate ceilings.

Many savings and loan associations were trapped between the increasingly higher cost of deregulated short-term deposits and the low return on their existing fixed-rate assets, particularly after October 1979 when the Federal Reserve changed operating procedures, causing a three-year interest rate spike. As dramatic evidence of this "trap," during 1981 and 1982 the thrift industry's average cost of funds leapt to a level nearly 200 basis points higher than the average return on portfolio, causing severe hemorrhaging of net worth. By 1981, many thrifts and banks had established net worth vigils, calculating the amount of months before they became legally insolvent. The industry lost nearly $9 billion in net worth in 1981 and 1982.

While not a subject of this testimony, I would be remiss in not mentioning the Congressional response to this very severe problem -- the Garn-St Germain Act of 1982. This Act gave new powers to thrifts to help them grow out of their financial bind and provided temporary net worth assistance for those institutions in severe trouble. Most thrifts have been slow, however, to take up the new powers and have remained dedicated to housing finance by concentrating on ARMs.

In contrast to the regulatory opportunities extended to thrifts to lighten the burden of their mortgage portfolios, the Administration now proposes to impose a special tax on housing finance. Mislabeled as a "user fee," the OMB recommended that a special tax be levied upon securities issues of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. If adopted, and put in place, we anticipate OMB proposals to increase the rate until the time when they will accomplish their true objective: to destroy the usefulness of Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System as consistent providers of funds for affordable housing in this country. The proposed tax would cripple an already fragile financial system and make housing more expensive for American homebuyers.

As mentioned above, most depository institutions rely heavily on short-term deposits to fund their mortgage portfolios. If these institutions hold only long-term, fixed-rate mortgages, their earnings plummet in a rising interest rate environment, since the average rate paid on the shorter-term deposits rises relative to the average rate earned on longer-term mortgages.

ARMs also attract more funds into housing. When rates rise, long term sources of credit dry up. In these periods, ARMs assure a continued supply of mortgage credit.

By offering ARMs, depository institutions can manage the maturity of their assets. ARMs enable them to reduce (but not eliminate) the sensitivity of their earnings to changing interest rates. Therefore, these institutions are less likely to curtail the availability of mortgage credit at certain stages of the business or interest rate cycle.

The ARMs authorized in 1981 differ from earlier VRM products by allowing for the transfer of more of the interest rate risk from the lender to the borrower and by permitting consumers to choose the amount of interest rate risk they wish to take. The early VRMs mandated the sharing of that risk between borrower and lender. Of course, if ARMs without caps predominate, lenders and investors may then absorb the full risk again (credit risk) because they will own the property if the borrower cannot make the payment or if negative amortization gets too high.

Until recently, consumer wariness about ARMs was compounded by confusion from all the ARMs permitted by the 1981 regulatory changes. Differences in advertising practices, use of inconsistent terminology to describe alternative mortgage options, and the simple inability of lenders and Realtors in some instances to explain these differences significantly slowed consumer acceptance of ARMs.

Since early 1984, a positively sloped yield curve (where short term rates are significantly below long term rates), the voluntary market acceptance of more safeguards and housing affordability constraints have stimulated greater market acceptance of ARMs. In March of 1985, the FHLBB reported that 50 percent of all new conventional mortgages issued by savings and loan associations were ARMs, up from 30 percent two years earlier, but down from 60 percent in March 1984. With somewhat lower rates on 30-year mortgages, there is slightly less demand for ARMs at this time. (See Exhibit A).

The National Council of Savings Institutions (NCSI) reported the results of a survey conducted during December 1984 in which its members described their ARM and fixed-rate mortgage activities during the second half of that year. Nearly 300 institutions responded that 73 percent of the mortgages made last year were ARMs, and 94 percent of the respondents offered ARMs.

Interestingly, the data collected by the NCSI further revealed that, while more than 75 percent of all standard fixed-rate loans were sold into the secondary market, only 40 percent of ARM originations made by their members were sold. Thrifts prefer to hold a greater percentage of ARMs in portfolio, while originating most fixed-rate loans for sale to the secondary market.

The rapid development of ARMs as an alternative to longer term fixed-rate loans has contributed substantially to the continuing strength in home sales and new construction in many areas of the country, despite high interest rates. Rates on 30 year fixed-rate mortgages have declined to around 13 percent while ARMs are now available at initial rates of 9 3/4 to 10 1/2 percent.

The most recent housing starts figures attest to the health of the housing sector that is due in large part to such alternative and less costly mortgage financing.

Finally, and this is an important point, if ARMs had been accepted and broadly used by the public ten years ago, a strong case could be made that most portfolio lenders would have never experienced such severe financial difficulties. The net worth capital certificate program enacted two years ago would have been unnecessary as would the extension of non-residential mortgage asset powers to thrifts. And, mortgage interest rates would have been lower, both for ARMs and fixed-rate loans. Families borrowing money today are effectively "paying for" the borrowers of ten years ago who still have 8 percent mortgages as well as paying a premium for interest rate risk. If most or all existing mortgages were adjustable, neither of these payments would be necessary.

B. Fannie Mae's Role in Developing the ARM Market

Fannie Mae, as a portfolio investor and guarantor of mortgage-backed securities (MBS), is a financial intermediary. We borrow funds in the short and intermediate-term financial markets and invest in fixed-rate mortgages (FRMs), second mortgages and various types of ARMs. As of March 31, 1985, we owned over $88 billion in mortgages and had outstanding guaranteed MBS of $39 billion, the total representing approximately one in every 10 mortgages in America. Fannie Mae owns $69 billion in single-family FRMs, nearly $2.9 billion in second mortgages, and over $13 billion in ARMs. The remainder are multifamily loans.

In late 1981, Fannie Mae began buying ARMs, acquiring about $100 million that year. We were the first major secondary market participant to purchase ARMs. In response to the insistence of lenders, builders and buyers, Fannie Mae purchased over 120 different types of ARMs in 1982. That year we acquired $3.2 billion of ARMs, an additional $4.2 billion in 1983, and $5.4 billion in 1984. We purchased $1.7 billion in ARMs in the first quarter of this year. In large part, because of our willingness to provide a market for ARMs and fixed-rate mortgages in 1982, many builders have told us "we would not have survived in the tough housing market of 1982 without Fannie Mae."

In 1983, we reduced the number of standard ARM plans from eight, as originally introduced in 1981, to three. This was done to bring standardization to the ARM market -- essential for attracting mortgage capital, especially from non-traditional lenders -- and to reduce buyer confusion.

During 1983, Fannie Mae took the lead in offering various consumer safeguards like interest rate and payment caps. These protections eased consumer nervousness about ARMs and contributed to the increased popularity of ARMs.

These practices spread quickly through the market. In fact, after Fannie Mae announced its $1.6 billion "select commitment" ARM in September 1983, thrifts and other lenders began offering the same product, at prices equal to or less than Fannie Mae's.

In early 1984, Fannie Mae changed its policy to require that all ARMs contain interest rate caps, payment caps or both. In January 1985, we announced that interest rate capped ARMs would be standard products. Finally, last Saturday's Washington Post described Fannie Mae's leadership in developing convertible ARMs. A convertible ARM is one where the borrower can convert an ARM to a fixed-rate loan at some designated time in the future. A convertible ARM allows a buyer to qualify at the lower rate of an ARM, but lock-in a fixed-rate mortgage three to five years after buying the house. It is the most recent example of our role in helping homebuyers get a mortgage and keep it.

A chronology of Fannie Mae's ARM announcements is included as Exhibit B. Exhibit C is our most recent announcement.

We are proud of our track record in designing more liquid and financially prudent ARMs. Fannie Mae led in the introduction of consumer protection features in ARMs. We have spent substantial corporate resources on this effort. Our development work, and that of many other lenders, has reaped rewards. We can now discuss "common" ARM characteristics. That would have been nearly impossible two years ago.

C. Characteristics of ARMs: General Description

The first essential characteristic of an ARM is the index upon which loan adjustments are based. Under existing regulations, lenders can determine the index, as well as the margin or spread they use to calculate the rate adjustments. The choice among available indices can mean different spreads among otherwise comparable ARMs up to as much as three percentage points. Moreover, lenders with the same index may use different methods to calculate rate adjustments.

The second characteristic is the frequency of interest rate and payment adjustments. In most instances, the two are identical, but interest rates may change more frequently than payments. Until recently, three and five year ARMs -- where the interest rates and monthly payments adjusted every three or five years -- were the most popular. One year ARMs have become much more popular since early 1984.

Many ARMs contain annual interest rate caps (another common characteristic), which typically limit interest rate adjustments to one or two percentage points per year. Payment caps are also available that transfer any interest rate increases that would exceed a specified monthly payment limit to the next adjustment period, thereby delaying the consumer's higher rate. A tradeoff for such "caps" is that the initial mortgage rate is usually lower without them because the lender is absorbing more risk with caps than without.

Fourth, in addition to periodic caps, many ARMs contain a "lifetime cap" that limits rate changes to some maximum up or down fluctuation throughout the life of the loan. Although lifetime caps are becoming more commonplace, some ARMs continue to be made without such ceilings or floors.

In certain ARMs, the use of "payment caps" results in negative amortization. Since monthly mortgage payments may not cover scheduled interest and principal payments, deferred interest can result. When this is added to the loan balance, it is known as negative amortization because the loan balance increases rather than declines. Many ARMs today limit negative amortization to 125 percent of the original mortgage amount.

Another frequently available feature of ARMs is assumability, usually with the approval of the lender. In contrast, most fixed-rate loans are not assumable but are due on sale of the property. The assumption of an existing ARM is often accompanied by an adjustment in the lifetime cap or other terms of the loan, and may be permitted to occur only once.

Finally, a graduated payment feature is often available. Under a graduated payment ARM (GPARM) plan, initial monthly payments begin at a reduced level and increase by additional fixed percentages at specified times throughout the early years of the mortgage. Payments rise on a predetermined schedule as with a fixed-rate, graduated payment loan. Subsequent payments may vary because interest rates change.

Graduated payment ARMs are used mainly by first-time homebuyers. The lower initial payments assist prospective homebuyers with low current incomes to qualify for a larger mortgage in anticipation of reasonably foreseeable income growth. The ability of upwardly mobile families to purchase a first home earlier than might otherwise be possible is an obvious benefit to young families and the housing industry alike.

While most ARMs will generally contain these characteristics, consumer preferences change. To get a better understanding of what lenders are offering and consumers are demanding, Fannie Mae conducted a survey of lenders in June of last year. These results have been supported by more recent data collected by thrift trade groups.

D. What Kind of ARMs are Being Offered Today -- A Fannie Mae Survey

To help the Subcommittees and their staffs better understand what ARMs consumers are demanding in today's market, Fannie Mae conducted a survey of 250 lenders -- thrifts, mortgage bankers and commercial bankers -- during June 1984. We believe the results continue to be valid. The results are instructive, and we would be happy to discuss them in greater detail if any member of the Subcommittees so wishes.

The highlights of our survey are:

1. The most popular ARM -- by far -- is a 1-year ARM. Two hundred and thirty three (233) lenders surveyed offered this loan, while forty-five (45) offered 3-year ARMs and only nine (9) offered 5-year ARMs. Two years ago, 5-year ARMs were the most popular. (Some lenders offered more than one type of ARM which is why the numbers do not add to 250.)

2. Most lenders surveyed (198 out of 250) offered an interest rate cap, usually a 2 percent annual cap and a lifetime cap between 4 and 6 percent.

3. Seventy-seven (77) lenders offered a payment cap, all at 7 1/2 percent per year.

4. Eighty-three (83) lenders permitted negative amortization, but all 83 imposed a ceiling of 125 percent of the original mortgage amount.

5. Fifty-six (56) lenders set their initial payment rate below the accrual rate, but only ten (10) lenders had a greater spread than 250 basis points between the payment and accrual rate. We asked this question to find out if "teaser" rate loans were popular.

6. Sixty-eight (68) lenders allowed borrowers to convert an ARM to a fixed-rate loan within several years after the loan was made.

7. Margins -- the spread between the index and the mortgage rate -- ranged from 100 to 375 basis points, with the majority falling between 200 and 250 basis points.

8. Most lenders charged between 1 1/2 and 3 points up front on an ARM.

The survey's results and more detailed charts are included in Exhibit D.

These survey results lead to a few general, but nonetheless important, conclusions.

First, the use of teaser rates (finding #5) is rare. Most lenders do not heavily discount ARMs. This is probably because of all the publicity by the media and others (including Fannie Mae) during the last year and a half. Our 250 basis points limit on one-year ARMs has become a market standard. In fact, industry sources report that the really low teaser rate loans offered in Texas last year have stopped. Most lenders understand that heavily discounted ARMs magnify the incidence of default tremendously.

Second, many lenders offer either an interest rate or payment cap, following Fannie Mae's practice not to purchase any loans without such caps. Only a few lenders offer ARMs with unlimited adjustments.

Third, consumers are more and more aware of the importance of caps and other safeguards. They are demanding loans with these protections, and lenders are offering them.

Fourth, consumers realize that one-year ARMs are necessary if they are to afford to purchase a home. Two years ago, when rates were lower and appeared to be staying there, 5-year ARMs were the most popular. With higher rates, the vast majority of consumers are demanding 1-year ARMs.

Finally, interest rate risk is being shared by lenders and borrowers, as demonstrated by the wide use of caps, rather than being shifted entirely to borrowers. This is a healthy trend, one that should be encouraged.

As I mentioned earlier, these findings are corroborated by more recent survey findings by industry trade groups. The National Council of Savings Institutions just reported that in the second half of 1984:

- interest rate caps -- averaging 2 percent per year and 6 percent over the life of the loan -- were used in 82 percent of the ARMs closed by their members;

- two-thirds of the institutions surveyed qualify buyers at the initial interest rate; and,
- one-third of ARMs closed used Treasury indices, with the cost of funds and FHLBB indices being the next most popular.

These findings and conclusions are important. They show that lenders are sensitive to the fact that buyers need assurances or safeguards if they are going to demand ARMs. The findings also show that potential homebuyers are becoming more sophisticated as they shop for mortgage loans. If buyers were not demanding ARMs with caps, they probably would not be offered. Finally, the findings hint that ARMs can benefit buyers -- so long as buyers shop for the right kind of ARM. These benefits are discussed next.

E. The Benefits of ARMs to Buyers

Given the increased use of safeguards like interest rate and payment caps, ARMs have become very popular with buyers. The short-term nature of ARMs can result in significant cost savings. For example, a homebuyer expecting to move within a five-year period may benefit from an ARM if the yield curve is upward sloping, since he or she does not need to pay the yield premium required to obtain long-term, fixed-rate financing.

ARMs also appeal to families with above average incomes because they can assume more easily the risk of any reasonably foreseeable interest rate fluctuations.

An ARM is not, however, a mortgage for only the upwardly mobile young and the affluent. An ARM, if prudently selected to meet reasonable income expectations and with safeguards, is demonstrably less expensive in many cases than the traditional fixed-rate mortgage.

A series of simulations by the U.S. League of Savings Institutions of various ARMs and fixed-rate loans demonstrates the cost benefit of many ARMs for buyers. The League simulated the experience of 19 different ARMs over a 40-month period, beginning in September 1980. They compared these ARMs to a 30-year fixed-rate mortgage at 12 percent, the prevailing rate on those loans at that time.

The results show that 11 of the 19 ARMs carried lower average rates than a 12 percent fixed-rate loan, i.e., buyers would have been better off over that period with these 11 ARMs. Over the 40-month period, which contained the widest swing in interest rates we have yet seen, borrowers with some ARMs saved as much as 200 basis points over a fixed-rate loan. An 80-month simulation, derived by repeating the interest rate scenario in the shorter period, resulted in 7 of the 19 -- roughly one-third -- of the ARMs carrying lower average rates than the 12 percent fixed-rate loan.

Many, but not all, of those ARMs where the consumer received a better deal incorporated rate or payment caps.

Finally, many people forget that ARM rates can fall as well as rise. Borrowers are not locked into high-rate loans which they can refinance only by paying more fees. Many borrowers taking out ARMs in 1982 and early 1983 found their monthly payments dropping at the first adjustment. Because Fannie Mae owned many of these loans, we estimate that we earned over $40 million less in pre-tax income because of downward adjustments. This is a significant consumer benefit that should not be overlooked.

Not all ARMs have interest rate or payment caps, even though our survey and figures published by others show that most do. And, there have been some isolated instances of other abusive practices. The extent of these practices is discussed in the next section.

II. ABUSIVE ARM PRACTICES: PROBLEMS FOR HOMEBUYERS AND LENDERS

The appearance of "teaser" rate mortgages in the first quarter of 1983 -- involving deeply discounted rates offered for the initial period of the mortgage -- alarmed many observers. The interaction of the initial discounted rate with other features of the loan can confuse even the most sophisticated borrower in comparing mortgage alternatives. And, these loans are dangerous to homebuyers and lenders because individuals may qualify for a mortgage that they can not really pay for, resulting in greater mortgage defaults and foreclosures. Qualifying a borrower at an artificially low rate does not do him or her a favor.

A. "Teaser" Rates and "Payment Shock"

In recent months, both industry and pubic interest representatives have expressed concern with the growth of teaser rate mortgages, which can cause "payment shock."

For instance, the National Association of Home Builders (NAHB) adopted a resolution last year to work toward more standard ARMs and better disclosure of ARM terms for buyers. The National Association of Realtors (NAR) held a conference only yesterday to discuss what is coming next in ARMs.

We define payment shock as a significant unexpected increase in monthly payments to borrowers which they may not be able to afford. These payment increases can result from low initial year, below-market rates adjusting rapidly to market rates, increasing monthly payments in one year by 20 percent or more. Payment shock is not a true threat to borrowers with most ARMs, as shown by our survey. As mentioned earlier, most ARMs offered today have interest rate caps and many others have payment caps. But, payment shock can be a problem when there are no caps, borrowers are qualified at the low initial rate and would not qualify at significantly higher rates.

Concern about payment shock is not new. When FHA introduced the graduated payment mortgage (GPM) in the late 1970s, there was serious debate about whether a borrower could handle a series of pre-scheduled payment increases. With rising incomes, GPMs would be no more "dangerous" than regular fixed-rate loans, and they did help more young families buy a home. The FHA GPM with annual 7 1/2 percent payment increases for five years became the most popular.

When Fannie Mae introduced buydowns in 1981, followed by graduated payment adjustable rate mortgages (GPARMs), our annual 7 1/2 percent payment ceilings became the accepted industry standard.

To minimize any danger of payment shock, we offered optional payment caps as standard features of our one-, three-, and five-year ARM products in May 1983. In February of 1984, Freddie Mac adopted this same standard.

To put a 7 1/2 percent annual payment increase into perspective and assuming a borrower qualifies at Fannie Mae's maximum payment-to-income ratio of 28 percent, this size annual payment increase can be fully offset by a 2.1 percent annual increase in the borrower's income. If the borrower chooses, he or she may absorb an increase greater than the 7 1/2 percent standard.

Beginning in the last half of 1983 and continuing to the present, greater consumer protections, a positively sloped yield curve and a widening of the spreads between ARMs and fixed-rate loans resulted in a tremendous surge in ARM originations, as well as a shift from longer term ARMs with three- and five-year rate adjustments to those with one-year adjustment periods. For example, over 97 percent of Fannie Mae's existing ARM commitments today are for one-year ARMs.

But later in 1983, in a new phase of competition, lenders began allowing the initial interest rate advertised to the consumer to be independent of the mortgage index and margin used to determine future interest rates. Thrift institutions, in particular, led the market in the recent ARM pricing "war," as they found themselves flush with cash and eager to invest in ARMs. Builders also sometimes engaged in various types of "buydowns," particularly in areas that were somewhat overbuilt.

By early 1984, the "payment shock" issue centered on a limited range of seemingly abusive ARMs with initial rates set significantly below market rates and with no caps imposed on future increases. Such artificially low initial rates, or "teaser" rates, alarmed many because they "entice" unwary borrowers into loans with built in traumatic payment adjustments after the initial period. The most egregious examples of these "teaser" rate loans took place in the Texas market, where a large supply of dollars in depository institutions chased a more limited demand for mortgages. As mentioned earlier, teaser rate loans in Texas have just about disappeared from the scene.

In October 1983, after Fannie Mae had already introduced payment and rate caps on its ARMs, Freddie Mac prepared a series of ARM examples for the Housing Roundtable that analyzed how payment and interest rate caps prevent payment shock. Freddie Mac deliberately selected origination dates for 95 percent loan-to-value ratio one-, three-, and five-year ARMs that would force adjustments when the spread between the initial rate and the adjustment rate would be at its highest (e.g., one-year and three-year ARMs were originated in September 1978, and the five-year ARMs in September 1976). This worst case analysis shows that uncapped ARMs would have required a payment increase of:

- 46.4 percent in 1981 for a one-year ARM;
- 68.9 percent in 1981 for a three-year ARM; and
- 80.5 percent in 1981 for a five-year ARM.

With rate and payment caps, the only ARM that had the potential for payment shock was the five-year ARM with 7 1/2 percent annual payment caps and a limit of 125 percent on negative amortization. In 1982, the negative amortization limit for that particular ARM required the mortgage to be refinanced, resulting in a payment increase of 48.2 percent. Although the Freddie Mac examples do not address so-called "teaser" rate plans, the value of rate and payment caps in preventing payment shock is clear.

Recent media coverage of ARMs has emphasized the payment shock problem. But the practices most likely to result in such payment shock for borrowers are, in our experience, not widespread. FHLBB statistics indicate that few major lenders continue to offer any non-rate capped ARMs. (Exhibit E).

Recent efforts by the housing finance industry to eliminate isolated market abuses are encouraging. Fannie Mae is actively involved in promoting such efforts. Our standard ARM product lines require rate or payment caps. And, we continue to emphasize the importance of sound underwriting of ARMs.

The use of teaser rates and misleading marketing practices can be halted by improved disclosure of mortgage terms and heightened consumer awareness of their dangers. An informed consumer is the best defense against these practices.

B. Interest Margins

Some lenders make up for low initial teaser rates by incorporating large ARM margins. Margins are the spread between the index and the mortgage rate.

As indicated in various surveys, the usual margin is 200 to 250 basis points. This spread pays for the difference in the lender's cost of funds over the index, administrative costs, remaining interest rate risk borne by the lender and profit.

To offset initial interest rates that may even be below the index, some lenders charge higher margins, as high as 375 basis points according to our survey. A good deal for the borrower initially may not be a good deal later on. Fortunately, our survey shows that most lenders do not charge high margins. Competition keeps these margins at a reasonable level.

Potential homebuyers should be told exactly what their margin will be. This can be done through detailed disclosure by the lender. In some cases today, that is not done and should be corrected.

C. Choice of Index

Sufficient flexibility for lenders in designing ARMs must be assured, particularly with respect to the index. Although competitive market forces, including the requirements of the secondary market, have narrowed the number of ARM indices, there is no index that meets the requirements of all homebuyers, lenders and mortgage investors.

Although no index exists that can perfectly satisfy the demands of all, three major types of indices are popular today. First, the one-year and three-year Treasury indices are particularly attractive to depository institutions because of the preponderance of liabilities at the short end of the maturity spectrum. A mortgage based on one of these indices also carries a lower initial rate, thus making it more attractive to consumers. However, short-term indices are more volatile than longer term measures, and give rise to either large swings in monthly payments or large amounts of "negative amortization." Thus, interest rate caps, payment caps and limits on negative amortization are necessary.

A second index is the five-year Treasury note. Generally, the five-year Treasury note is less volatile than the shorter term one-year note and is recognized to be entirely beyond the control of lenders. And, the 5-year Treasury index is readily acceptable by the secondary market.

A third popular index among California thrifts, in particular, is the cost-of-funds index computed either on a national or regional basis. Savings and loan associations frequently use this index because they believe it provides the greatest degree of interest rate risk protection.

Homebuyers need to shop carefully for an ARM, including the index used. Buyers should look for an index that is well publicized, moves according to market interest rates and is not under the control of lenders.

Exhibit F shows recent interest rate fluctuations of the more commonly used indices for ARMs.

D. New Credit Risks for Lenders

Possibly the least understood risk associated with the development of new rate-sensitive mortgages, such as ARMs, is the assumption of increased credit risk by lenders that accompanies the full or partial shifting of interest rate risk to borrowers.

Before 1981, long-term fixed-rate mortgages were virtually the only type of loan available to homebuyers. The risks for both borrowers and lenders were well known and fully understood. The risk of borrower default, that is, the "credit risk" to the lender, is limited under a fixed-rate loan to substantial changes in the borrower's personal income (caused perhaps by unemployment) or total indebtedness. Lenders and borrowers avoided foreclosure even in those circumstances by renegotiating the loan. In many instances, appreciation of the property easily satisfied the outstanding indebtedness.

With ARMs, another element enters the risk picture -- the possibility of higher monthly mortgage payments from rising interest rates. If the borrower can handle the increased payments, this risk is not very severe. Moreover, if payments fall because of lower rates, homeowners benefit. But, if buyers have difficulty meeting the higher monthly mortgage obligations, there is an increased chance of credit risk.

Mortgage Guaranty Insurance Corporation (MGIC) published a report entitled "Managing Risk: An Analysis of Payment Shock and Equity Erosion" that demonstrates the differences between a high risk ARM and a more prudently balanced instrument. MGIC concluded: "Prudent risk management requires a proper balance between payment shock and negative amortization." Both must be addressed in designing ARM instruments to protect borrowers and lenders. Thus, MGIC recently announced adjustments in its underwriting limits and guidelines to assure more prudent risk management.

MGIC represents that segment of the housing finance industry upon which many of the new risks associated with ARMs might fall. Mortgage insurance companies bear a significant risk in instances of default. Continued reliance upon traditional underwriting standards for ARMs may result in more frequent defaults. Moreover, negative amortization could eliminate borrower equity in the property over time and undermine the security of the mortgage itself as collateral for the indebtedness.

Underwriting standards for ARMs should differ from the static analysis traditionally used for fixed-rate loans. A more dynamic form of risk analysis must be used for ARMs to allow the lender to determine that, based upon various interest rate scenarios and borrower income patterns, the borrower will be able to meet his or her mortgage obligation. Under this underwriting formula, mortgage insurers and lenders will have to either reject higher risk loans or increase insurance premiums on loans that demonstrate relatively higher credit risk.

The MGIC analysis shows that mortgage insurance companies are beginning to adjust their underwriting guidelines. The tightened ARM guidelines announced by MGIC are welcome as a way to avoid the unhappy consequences likely to be encountered by homebuyers and lenders in foreclosure. However, MGIC and Fannie Mae provide markets; they do not regulate those markets. Therefore, our influence is limited to loans that MGIC will insure or Fannie Mae will purchase.

E. Self-Regulating Initiatives of ARMs Market Participants: Fannie Mae's Role

The mortgage finance industry has taken several steps to address the potential problems arising from perceived market abuses and advertising practices even though these abuses have been the exception, not the rule. Fannie Mae has been and will remain in the forefront of those efforts, as explained below.

First, all ARMs that Fannie Mae purchases must have either an interest rate cap, a payment cap (to be exercised at the home buyer's option), or both. Our guides require servicers to notify mortgagors of their option to invoke the payment cap.

Second, I announced last year that Fannie Mae would restrict its purchase of one-year ARMs to those loans with initial year discounts of not more than 2 1/2 percent below our posted market rate. This is quickly becoming a market standard and should discourage teaser rate ARMs.

Third, we have already tightened up on graduated payment ARMs because of the possibility of excessive negative amortization. We will only purchase one-year GPARMs if they have a loan-to-value ratio not exceeding 90 percent, rather than 95 percent, the standard with other types of mortgages. We also reduced the maximum ratio for all (1-, 3- and 5-year) GPARMs. Finally, we no longer allow buydowns under negotiated commitments for ARMs and GPARMs.

Fourth, we have called upon the mortgage finance industry to police abusive and imprudent practices involving ARMs, especially deep discount loans, and to better educate borrowers about ARMs.

We continue to meet with representatives of the mortgage lending community and to work with them and regulatory officials to develop reasonable standards for new mortgages.

Other market participants, particularly mortgage insurers, have also begun to make necessary changes. More lenders and buyers realize that prudent safeguards are necessary.

While the industry is correcting many of the problems, some federal action is necessary. This is discussed in the next section.

III RECOMMENDATIONS FOR ACTION

A. Dealing with Payment Shock

Based on Fannie Mae's experience in the ARM market and the results of our survey, we recommend that the industry be encouraged to:

- originate ARMs containing reasonable interest rate or payment caps;
- limit initial interest rate discounts; Fannie Mae's limits appear to be a reasonable standard; and,

- limit negative amortization; the industry standard that is emerging is 125 percent of the original mortgage amount.

These three recommendations, which are being increasingly adopted by lenders, should correct the problem of payment shock.

B. Selection of An Index

We recommend that three elements be carefully balanced in selecting an index. The index should be easy to understand; should be beyond the control of the lender; and must be acceptable to secondary market investors.

The increasingly popular alternative of using one or more of the Treasury series as an index has several advantages. The Treasury market is highly competitive and well developed. Treasury indices are also easily available to borrowers and lenders.

Survey data collected by the Mortgage Guaranty Insurance Company, shown in Exhibit G, demonstrate the growing popularity of the Treasury series as an index for most new ARM originations. As shown, the Fall 1983 survey results disclosed the use of a one-to-five year Treasury series by nearly 80 percent of the responding lenders' ARMs plans.

C. Margins

Potential homebuyers must not only carefully consider the index used. They should also inquire about margins, i.e., the spread between the index and the mortgage rate. As our survey showed, these margins varied between 100 and 375 basis points, with the typical spread being 200 to 250 basis points. Borrowers must often choose between a lower initial rate and a subsequent higher margin and a higher intitial rate with a smaller margin. Very often, the latter is a better deal.

D. Federal Disclosure Requirements

The federal financial regulatory agencies should not standardize ARMs. That is unnecessary and will discourage innovation. Government action is necessary, however, to help buyers obtain better information on ARMs. The Federal Reserve Board and Federal Home Loan Bank Board have published a consumer information handbook on ARMs, which must be given to every prospective borrower. That should help. The Federal Reserve Board, the Federal Home Loan Bank Board, and the Comptroller of the Currency also regulate lender disclosure of mortgage terms. Better disclosure for buyers will result from more uniform requirements by the regulators, better guidance by the regulators and stronger standards.

First, the Federal Reserve Board has issued Official Staff Interpretations on Regulation Z. Among other things, these interpretations clarified how the annual percentage rate (APR) -- which is the total cost of financing -- is to be calculated and how initial rates and APRs are to be advertised. The interpretation requires that the advertised annual percentage rate for discounted or variable rate transactions must be shown as a composite rate, i.e., the initial discount must be considered in calculating the APR.

However, it appears that regulators do not require lenders to provide information on the interest rate that will apply to the balance of the loan term as is required when a mortgage is bought down. This is especially curious since the Federal Reserve requires that banks advertise each interest rate and the length of time each rate will be paid when they offer time deposits that pay more than one rate over the life of the account.

Our two other recommendations for the Federal Reserve Board are to strengthen its enforcement of Regulation Z and to convene the three main regulatory agencies -- itself, the Comptroller of the Currency and the Bank Board -- to draw up model disclosure forms. The former is important because even though the Regulation Z provisions are fairly good, lender compliance is spotty. On the latter, since the Regulation Z provisions mesh with the ARM disclosure regulations of the Comptroller and Bank Board, a model disclosure form would go a long way toward uniformity and better consumer understanding. We are working with the Federal Reserve on that.

Second, disclosures now given by different financial institutions are not uniform, nor do they provide quantitative examples. Early VRM regulations of the FHLBB required that lenders not only offer consumers the choice of a standard fixed-rate loan, but also provide information to compare the cost of VRMs.

Disclosures were required to include a "worst-case" scenario under the VRM. When the FHLBB revised its regulations in 1981, they did not require thrifts to even disclose the initial index value or to provide any example of how the rate would vary over time. Moreover, lenders do not disclose loan terms until after a written loan application has been accepted by the institution, rather than when the borrower is applying for the loan. The regulations affecting banks are somewhat more comprehensive, and disclosure information must be provided no later than when a loan application form is first provided to the prospective borrowers.

In our opinion, adequate disclosures must be provided to consumers early in their search for a mortgage. Disclosures cannot be received before the time of loan application. But, consumers should get as much information as possible before they apply for a loan. We hope the Fed/Bank Board booklet will help.

Quantitative examples allowing comparison between mortgage products should be provided in the disclosure, including a worst-case scenario to allow the consumer to fully understand the possible fluctuations in monthly payments. We believe a worst-case disclosure should be adopted immediately by the Bank Board and the Comptroller of the Currency.

We realize it is technically impossible to define a "worst case" with an uncapped ARM. By itself, this should encourage lenders to offer capped ARMs. However, lenders should be allowed to offer uncapped ARMs. But, their "worst case" disclosure should include the possibility of an increase in interest rates at least as great as if a capped ARM were offered. Moreover, the "worst case" for an uncapped ARM should be reasonable. It is meaningless to tell a buyer that mortgage rates could rise to

75 percent. They would not believe it and would think that disclosing that was silly. Perhaps the regulatory agencies could require a "worst case" disclosure for uncapped ARMs that, for instance, told the borrower what would happen to his or her monthly mortgage payments if rates rose by 5, 7 1/2 and 10 percent.

The disclosures provided by lenders under existing regulations do not help consumers understand the many features of ARMs. Explanations of the terms and provisions are highly technical and confusing, and basic features of the loan agreement are often buried in the documentation. Disclosure is not uniform among different institutions, which is key.

For example, the particular index, and its likely movement with respect to other indices, is seldom explained to the borrower. The effect of particular caps and the possibility of negative amortization are usually not explained adequately. In our opinion, there should be greater standardization of required disclosures and terminology plus quantitative examples to allow comparison shopping. Prospective borrowers should have sufficient information to understand the myriad options available and benefits and risks involved with ARMs.

We believe that these additional federal disclosure requirements, in conjunction with the initiatives of the industry to correct abusive practices, will result in the public's acceptance of ARMs as a superior alternative to traditional longer term mortgages.

IV. SUMMARY

The proliferation of ARMs having significantly different features, and the difficulty of comparing the relative merits of ARMs and fixed-rate loans, confuse both borrowers and loan officers. Confounded by the availability of deep discounts, teaser rates, aggressive marketing practices and inadequate disclosures, the typical homebuyer today may throw his or her hands up in total frustration. However, it would be a mistake to conclude that ARMs threaten homebuyers or undermine the future of homeownership in America.

Our recent survey and those of others show that unsound practices are limited. Most lenders offer ARMs with interest rate caps, payment caps and/or limits on negative amortization. Few lenders actually offer teaser rate mortgages. Homebuyers have been quick to realize that certain protections are important.

The future availability of affordable credit for homebuyers and the successful recovery of the thrift industry depend to a large extent on ARMs being accepted by prospective homebuyers as an alternative to long-term, fixed-rate mortgages. The yet unresolved questions and perceived problems of ARMs must be addressed. But government standardization of ARMs is unnecessary.

Continued mortgage affordability also means that the Congress should reject soundly the OMB's proposed housing user taxes. These fees will raise costs for homebuyers and threaten the viability of Fannie Mae and thrifts. The benefit that ARMs given Fannie Mae and thrifts could be completely undone by those user taxes.

Recent industry initiatives to correct the advertising and marketing practices of a few, and to stimulate greater consumer understanding and familiarity with the benefits and importance of ARMs, are taking effect. Fannie Mae has been in the forefront of that effort. The benefits of ARMs to consumers, lenders, and the housing industry should not be lightly discarded because of initial confusion with a new product and unfounded fears. It is important to recognize that in a deregulated financial marketplace, housing credit must be competitive with other uses of credit. ARMs are just the product necessary to assure such competitiveness.

Exhibit A

Percent of New Conventional Home Mortgages Closed With Adjustable Rates

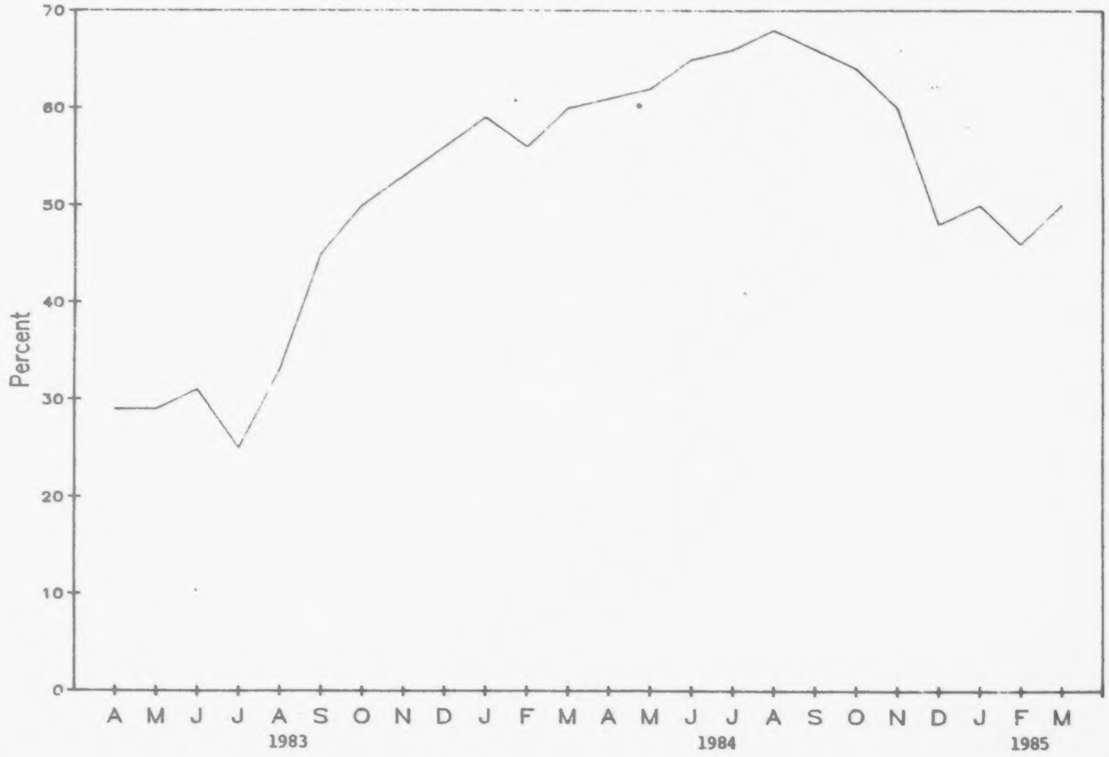


Exhibit B Page 1

FANNIE MAE ARM CHRONOLOGY

July 1981	Fannie Mae introduced eight ARM plans.
March 1982	Graduated payment ARMs introduced to provide lower initial monthly payment to borrowers.
Late 1982	Louis Harris consumer survey commissioned, survey results demonstrated consumer interest in ARMs and preference for alternative financing plans from which to choose.
	Lenders surveyed for ARM preference, to assist in development of marketable programs.
	To meet market demand, over 120 ARM plans purchased on negotiated basis in 1982.
May 1983	Simplified ARM product line to three plans based on 1-, 3- and 5-year Treasury indices which are easy to use and understand. Incorporated payment caps as a standard feature of our ARM products.
	ARM servicing fee to lenders increased to 1/2%.
August 1983	ARM "flex" pricing introduced allowing greater flexibility to respond to market conditions when setting initial ARM interest rates.
September 1983	Reduced margins for 1- and 3-year ARMs, making it possible to offer lower interest rate ARMs.
	Select Commitment offered featuring ARMs with interest rate caps.
April 1984	Establishment of discounting limitations on standard ARM/GPARM plans.
May 1984	90% loan-to-value limitation established on 1-year GPARM.
	Introduced 5-year fixed payment ARM with interest rate caps (negotiated).
August 1984	90% loan-to-value limitation established on 3- and 5-year GPARMs.

Exhibit B Page 2

- December 1984 - Introduction of interest rate caps on 1-year ARMs as a standard product line.
- February 1985 - Established maximum allowable margin on ARMs of 300 basis points (3%).
- March 1985 - Announced joint Fannie Mae/Freddie Mac interest rate capped ARM documents (see Exhibit C).

Exhibit C Page 1

ANNOUNCEMENT

NO. 85-05

REFERENCE

☒ Lending	☐ Servicing	☐ MBS
☐ Selling	☐ Forms	☐

This announcement amends the guide(s) indicated above. Please keep it for reference until we issue a formal change following the end of this calendar quarter.

SUBJECT JOINT FANNIE MAE/FREDDIE MAC INTEREST RATE-CAPPED ARM UNIFORM INSTRUMENTS

We are pleased to announce that Fannie Mae will issue uniform ARM instruments for our interest rate-capped ARM Plans 5/0, 5/1 and 5/2 jointly with Freddie Mac. These changes do not affect the Notes and Riders for our interest rate-capped GPARM plans or the Addendums for the fixed rate conversion option.

The new joint instruments are for multistate use, except in: Alaska, Kansas, Kentucky, Louisiana, Texas, Virginia and West Virginia. State-specific joint instruments will be available for those states. All forms are dated 3/85 and will be available from our regional offices by the end of March.

Lenders may use either the Fannie Mae versions of the interest rate-capped ARM forms or the joint instruments. Because the changes are non-substantive, lenders may exhaust existing supplies of the Fannie Mae versions of these forms before reprinting the new joint instruments.

The Freddie Mac ARM Note and Rider (Forms 3602 and 3112, respectively) using the Cost of Funds Index may not be used for ARMs sold to Fannie Mae.

Below is a list of the form numbers for the new instruments that correspond to the Fannie Mae forms issued previously. Lenders may obtain a camera-ready copy of each form from our regional offices.

Exhibit C Page 2

ANNOUNCEMENT

NO. 85-05

Joint Fannie Mae/Freddie Mac
Uniform Interest Rate-Capped
ARM Instruments

Multistate	Note	Rider	Date
ARM Plan 5/0	3601	3107	3/85
ARM Plan 5/1	3501	3108	3/85
ARM Plan 5/2	3502	3111	3/85

State-Specific

The same multistate form numbers apply for state-specific forms except that each state form is assigned a suffix. For example, the ARM Note for an ARM Plan 5/0 in Alaska would be 3601.02.

The suffixes are as follows:

Alaska	.02
Kansas	.17
Kentucky	.18
Louisiana	.19
Texas	.44
Virginia	.47
West Virginia	.49

Robert J. Mahn
Senior Vice President - Mortgage Operations

EXHIBIT D Page 1

FANNIE MAE ARM SURVEY RESULTS - (number of lenders surveyed - 250)

1. How many lenders are offering 1-year, 3-year and 5-year ARMs?

   1-year ARMs - 233
   3-year ARMs - 45
   5-year ARMs - 9

   (Total does not add up to 250 because some lenders offer more than one type of ARM).

2. How many lenders offer different interest margins, e.g., 175, 200, 225 basis points, etc.?

   100 BP - 11
   125 BP - 2
   150 BP - 14
   175 BP - 10
   200 BP - 58
   225 BP - 35
   250 BP - 55
   275 BP - 23
   300 BP - 15
   325 BP - 2
   350 BP - 0
   375 BP - 1

   Note: 226 lenders responded to this question.

3. How many lenders charge initial rates that are less than the accrual rate? **56**

4. How many lenders charge an initial rate that is more than 2 1/2 percent below the accrual rate? **10**

5. How many lenders offer an option to convert to fixed-rate loans? **68**

6. How many lenders offer a payment cap? **77** (all at 7.5%)

7. How many lenders offer a rate cap? What are they?

   198 offer a rate cap

   86 offer 2/5 (2% per year and 5% lifetime)
   26 offer 2/5.75
   10 offer 2/4
   15 offer 2/6
   12 offer 0/5

   Note: Other lenders either didn't specify a particular cap or a very small number of lenders gave a cap like 2/7.

EXHIBIT D Page 2

8. How many lenders permit negative amortization? What amount?

83 permit negative amortization, all at 125%

9. What level of points do lenders charge, e.g., 2, 3?

0.00 points - 11
0.50 points - 2
1.00 points - 18
1.25 points - 1
1.50 points - 17
1.75 points - 1
2.00 points - 87
2.25 points - 5
3.00 points - 65
3.50 points - 12
3.75 points - 1
4.00 points - 4
4.75 points - 1

Note: 225 lenders responded to this question.

10. How many mortgage bankers were covered by the survey? Thrifts? Commercial Banks?

Mortgage Bankers - 130
Thrifts - 87
Commercial Banks - 33

11. What is the volume of overal originations (of lenders surveyed) to date in 1984?

$25.365 billion

12. What is the volume of ARM orginations (of lenders surveyed) to date in 1984?

$12.319 billion

Exhibit D Fig. 1

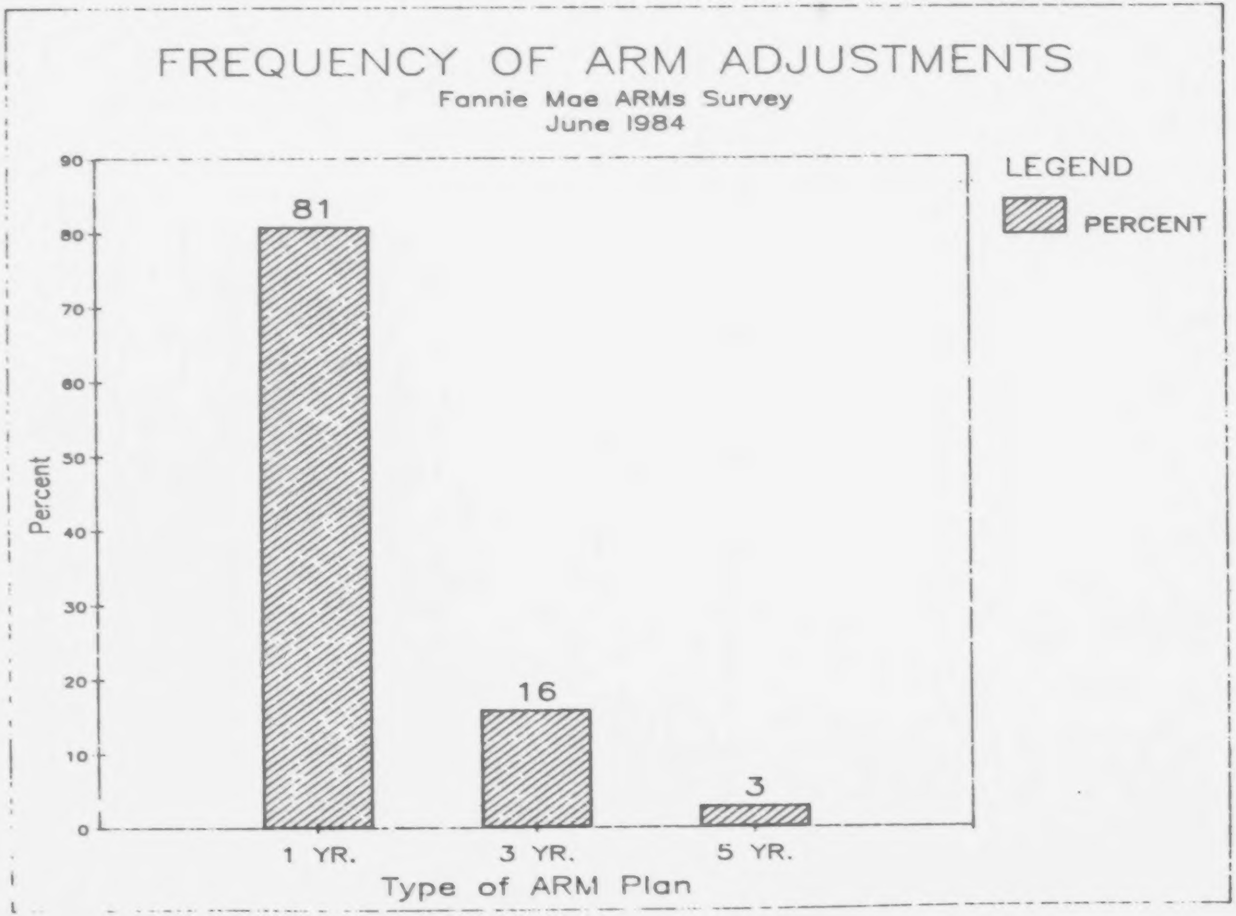


Exhibit D Fig. 2

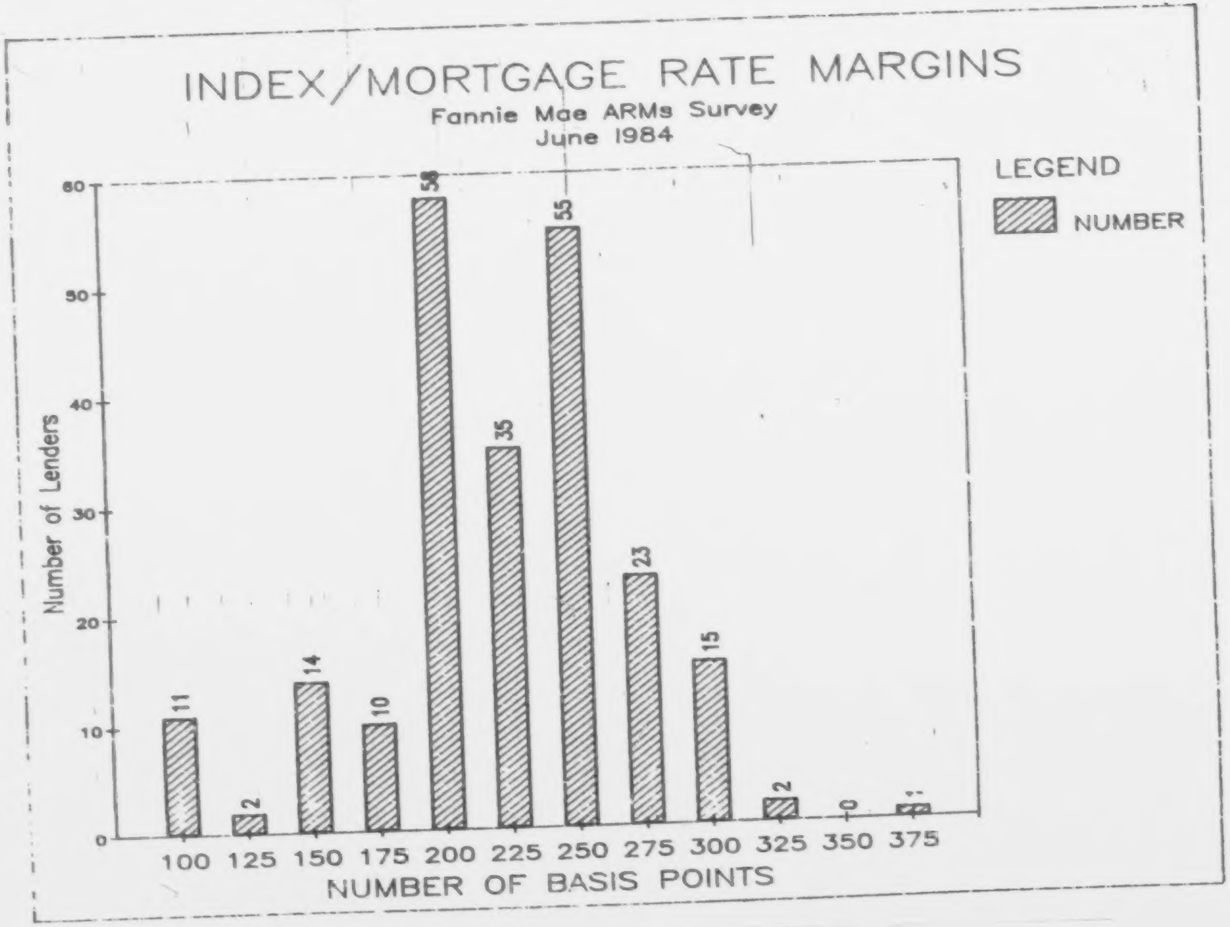


Exhibit D Fig. 3

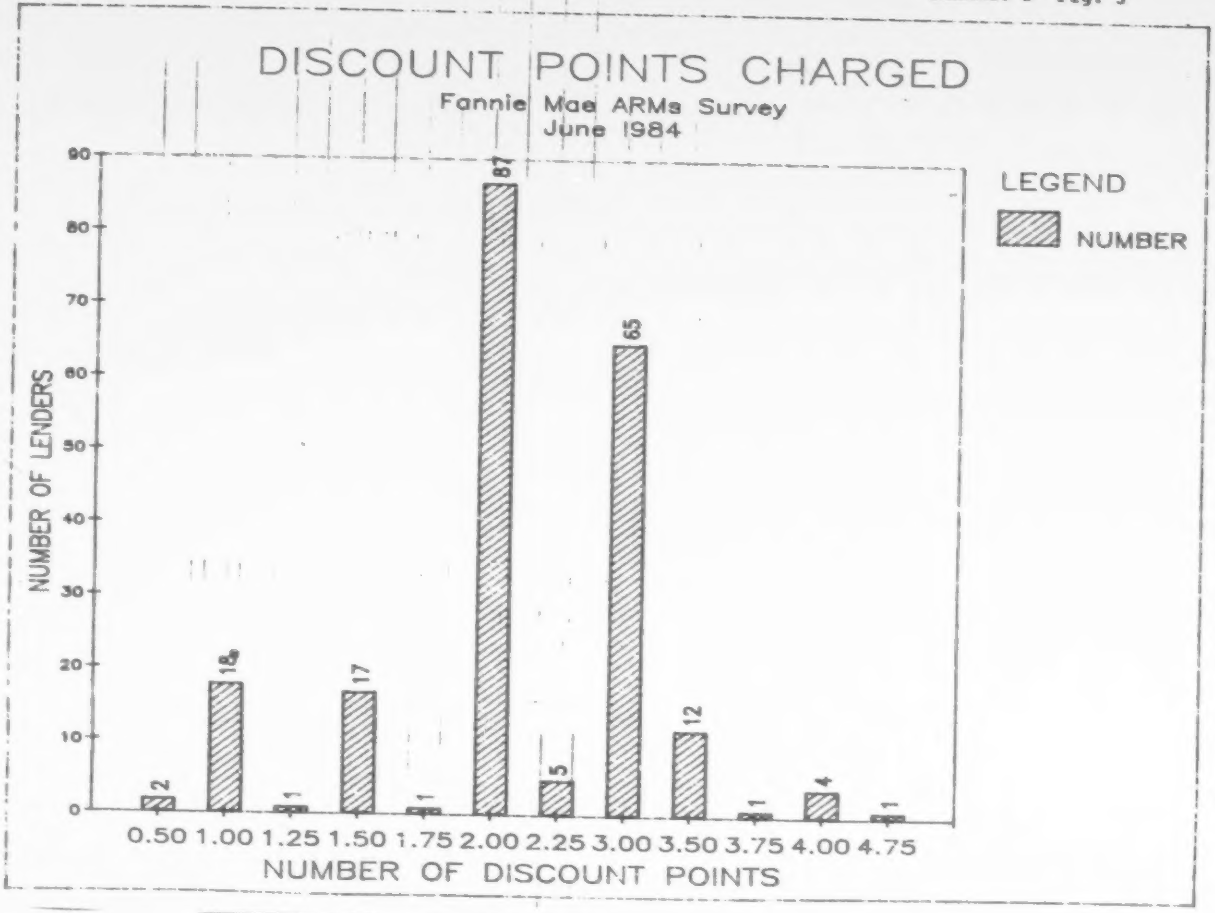


Exhibit D Fig. 4

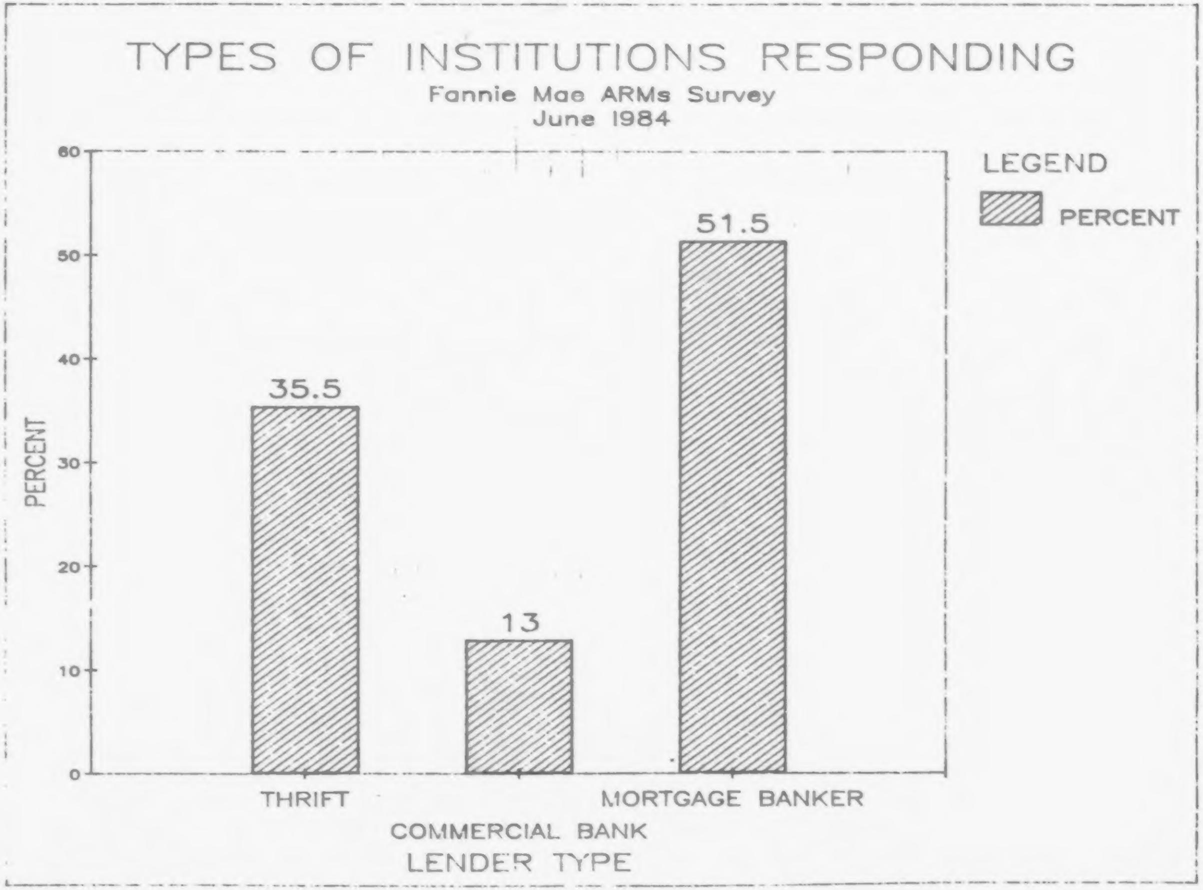


Exhibit D Fig. 5

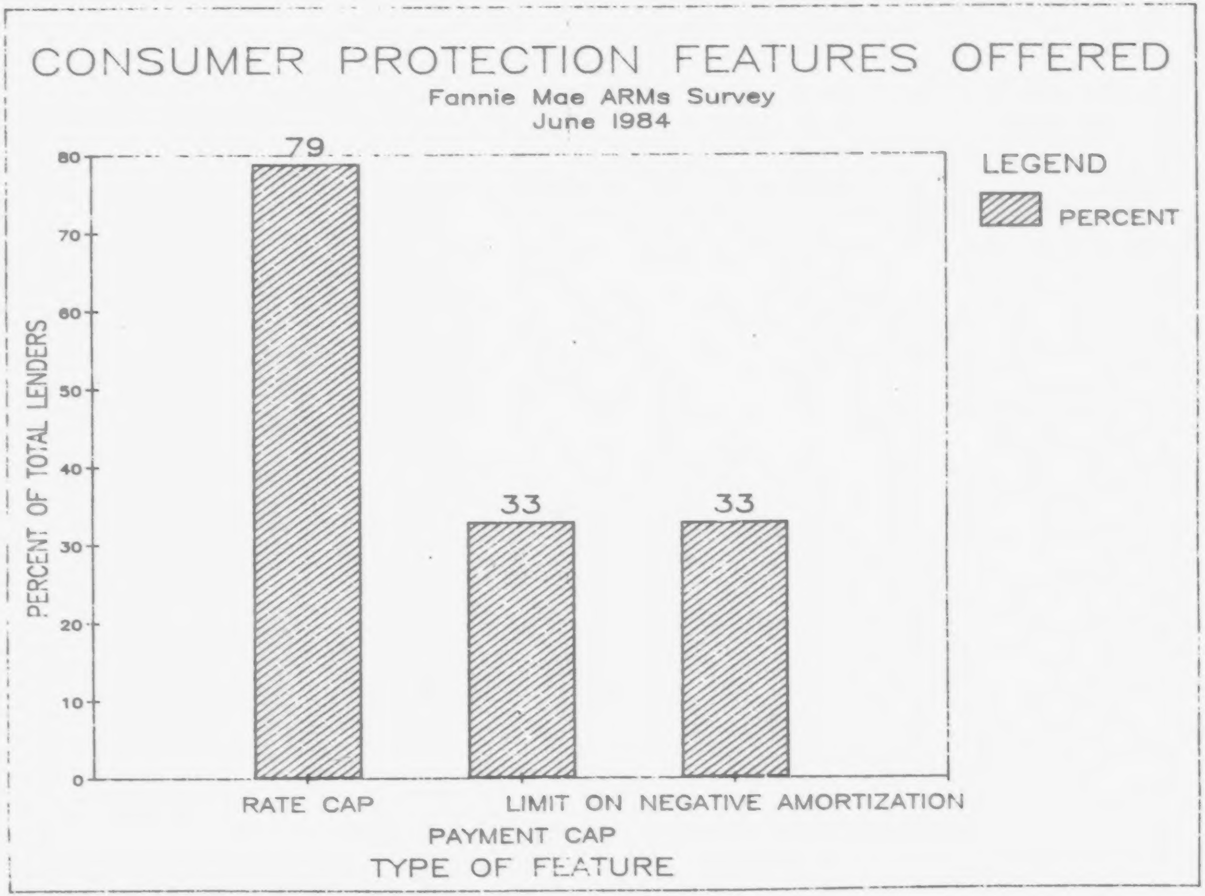
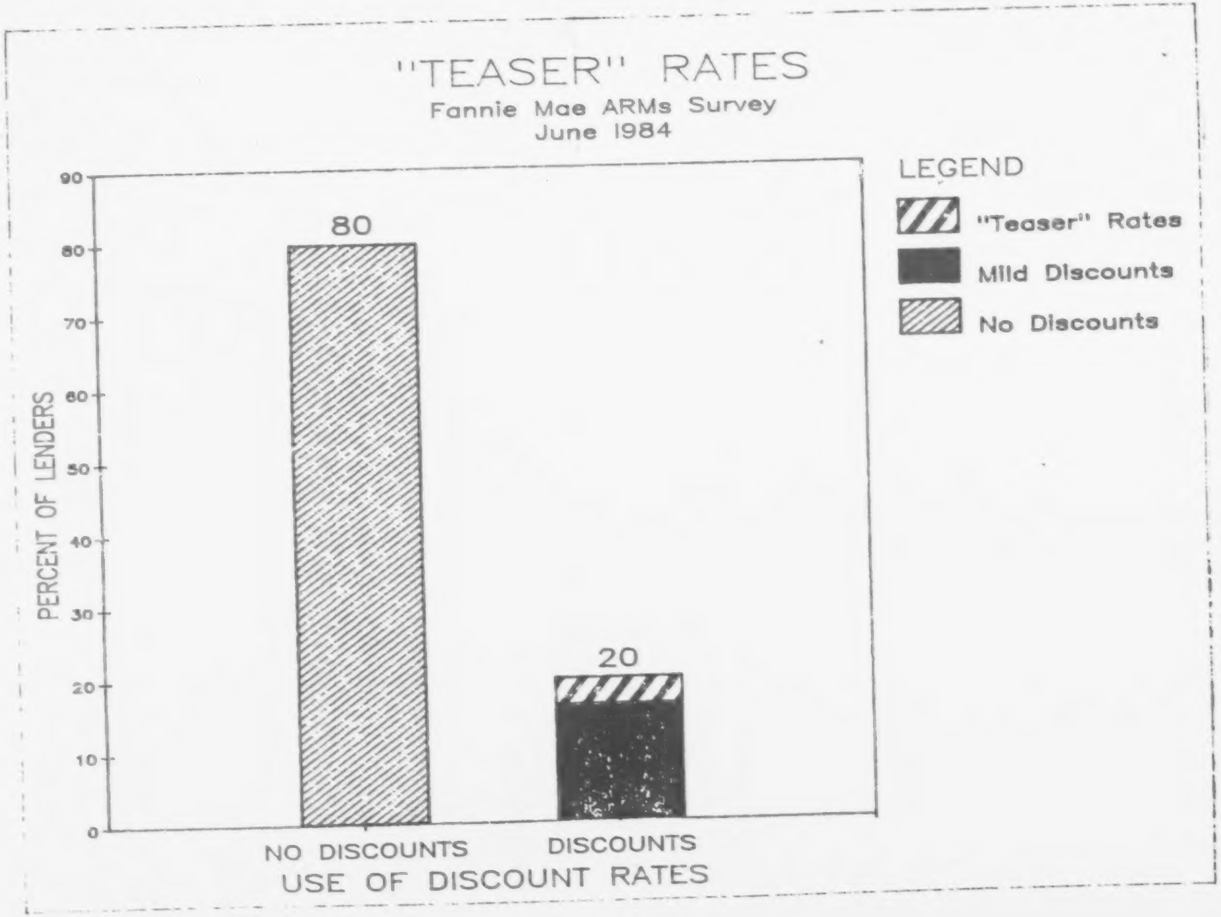


Exhibit D Fig. 6

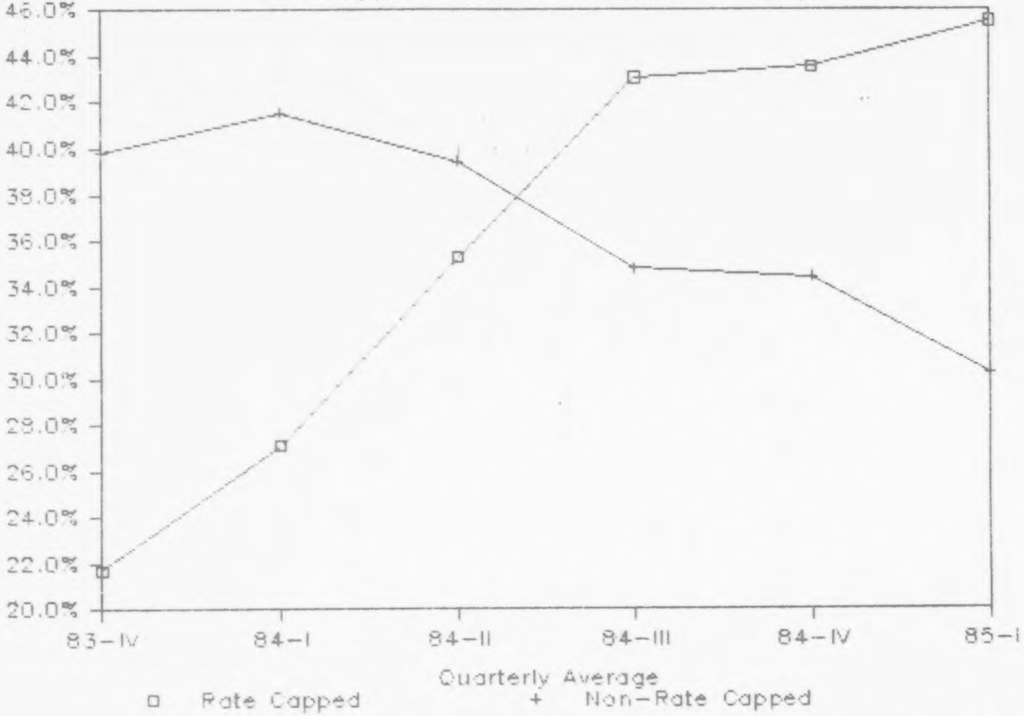


"TEASER" RATES

Fannie Mae ARMs Survey
June 1984

EXHIBIT E

Percentage of Major Lenders Offering
Rate Capped & Non-Rate Capped Mortgages

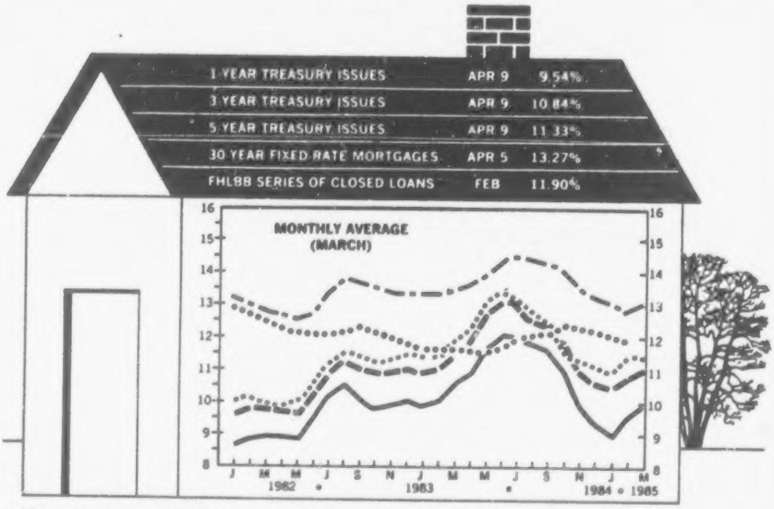


SOURCE: Federal Home Loan Bank Board
Fannie Mae Product Marketing
January 1985

EXHIBIT F

COMMON ARM INDICES

SOME COMMON INDEXES FOR ADJUSTABLE-RATE MORTGAGES



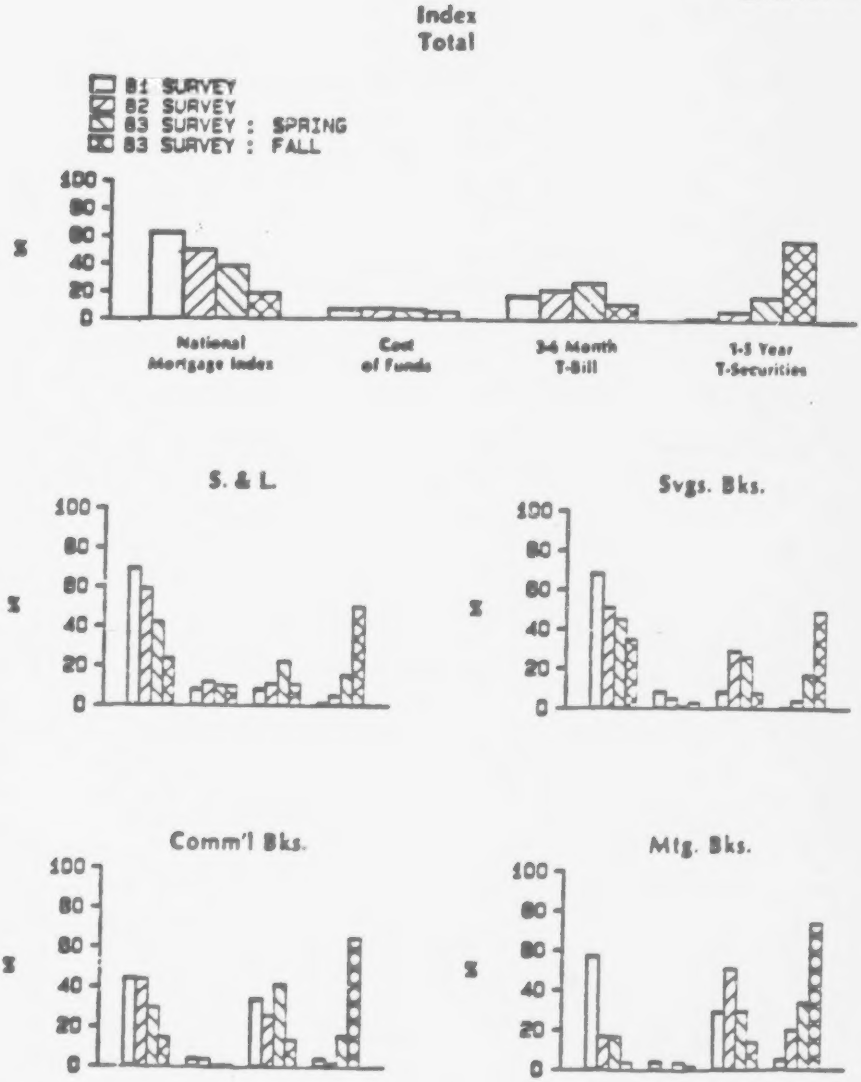
1 YEAR TREASURY ISSUES	APR 9	9.54%
3 YEAR TREASURY ISSUES	APR 9	10.84%
5 YEAR TREASURY ISSUES	APR 9	11.33%
30 YEAR FIXED RATE MORTGAGES	APR 5	13.27%
FHLBB SERIES OF CLOSED LOANS	FEB	11.90%

This chart,appearing weekly in the Real Estate Section, is designed to show the trends of some of the more common indexes used to set rates on adjustable mortgages. Borrowers facing adjustments can use the numbers at the top to get an idea of what their new rate is likely to be, assuming no caps or other special limitations. To do that, add the lender's margin to the applicable index. For example, if your loan is indexed to one-year Treasury issues and your lender's margin is two points, the current rate on your loan is 11.54 percent. Data on 30-year fixed-rate loans are included for reference; Treasury issues are adjusted to a constant maturity.

SOURCE: FEDERAL NATIONAL MORTGAGE ASSOCIATION; FEDERAL HOME LOAN MORTGAGE CORP.; U.S. TREASURY

SOURCE: The Washington Post

EXHIBIT G



Source: MGIC

Senator GORTON. Thank you, Mr. Maxwell.

Mr. Thygerson.

STATEMENT OF KENNETH THYGERSON, CHIEF EXECUTIVE OFFICER, FEDERAL HOME LOAN MORTGAGE CORPORATION

Mr. THYGERSON. Thank you, Mr. Chairman and members of this distinguished subcommittee. It is a pleasure for me to be with you today to talk about the ARM's issue.

I also have a more detailed statement, which I would appreciate being included in the record.

Senator GORTON. It will be so included.

Mr. THYGERSON. Thank you very much.

I think what you are going to hear, in the first panel at least, is much agreement and very little disagreement about the overall situation with respect to ARM's.

We have had some problems with ARM's in the past. These problems were identified about 1 year ago, and lenders, mortgage insurance companies, secondary market institutions, and regulators went to work to resolve those problems. So what we are hearing today—the message I have is that those problems are largely behind us. We have come a long way, and now they are a very desirable mortgage instrument for consumers.

AN IMPORTANT MORTGAGE INSTRUMENT

Mr. Chairman, I believe the ARM is and will continue to be an important mortgage instrument for consumers and lenders. It is especially important for the growing number of first-time home buyers who can't always afford large monthly payments in their first years of homeownership but can anticipate larger income growth in the years ahead.

We all recognize that there have been some uncomfortable growing pains over the last few years, but the industry's approach to ARM's has matured as a result of the guidance offered by the Congress and regulators as well as their own experience. Undoubtedly the development of ARM's has clearly shown that financing the Nation's housing needs is an evolving process that requires compromise and flexibility.

Freddie Mac's operations are guided by our congressional mandate to purchase investment quality mortgages and provide leadership in mortgage finance. This means that programs should be designed to take into account the needs of consumers, lenders, investors, and the housing finance system as a whole.

Our obligation is not simply to purchase what is already available in the marketplace but to evaluate needs and to develop programs to address those needs.

I would like to summarize today the principles that have guided Freddie Mac's efforts to facilitate the development of quality ARM's for consumers. I think in your opening statement, Mr. Chairman, you summarized the major issues very, very well.

First, ARM's should be well-designed and as standardized as possible.

Second, consumers need adequate information, adequate disclosure about ARM's, to understand the terms and conditions in order to make rational choices.

Third—and you pointed this out—criteria for underwriting ARM's ought to reflect the fact that they are different from fixed rate mortgages. As a result, the income criteria used in underwriting should be adjusted to reflect potential payment adjustments and the possibility of negative amortization.

Fourth, the private mortgage insurance industry is a crucial factor in assuring the safety and soundness of all ARM's, not simply the ones that we purchase.

Careful ARM design and standardization help consumers reduce the cost of shopping for a mortgage instrument, and minimizes the chances of making grave mistakes.

Freddie Mac owns 18,000 ARM's compared to almost 2.2 million single family fixed rate mortgages which we are currently servicing. We have had no hesitation about conceding temporarily the market share of fee income volume in order to more carefully evaluate the market and move toward greater ARM's standardization.

That standardization will help to assure a handful of quality ARM's products for home buyers, lenders, and investors alike instead of hundreds that only serve to confuse consumers.

Just as Freddie Mac has provided standardization in the marketplace for 30-year fixed rate mortgages, we are well along in establishing standards for ARM's both in terms of the documents as well as product design.

Freddie Mac has worked to standardize and put into plain language the mortgage documents on which ARM's are originated. In addition to minimizing borrower confusion, our standardization programs offer degrees of protection against interest rate changes that help to balance the risks between the borrower and the investor. Consumers need adequate information to make rational choices among the many options.

Similar hearings before your counterpart subcommittee in the House last August helped those members reach the conclusion that more uniform information on ARM's should be available.

The subcommittee called upon the Federal regulators and industry representatives, including Freddie Mac, to form a task force to develop a comprehensive public information brochure. That brochure was published, as indicated by Ms. Fairbanks, and is available. It is a quality brochure.

Because consumer awareness and understanding of the terms associated with mortgage loans are so crucial, Freddie Mac was the first to conduct consumer focus groups to evaluate home buyers' knowledge and understanding of the mortgages they choose.

Last June, I personally attended one of these groups outside of Washington and learned much more about how home buyers search for information about the different types of mortgage financing available, how consumers evaluate the risks they face when mortgage rates adjust upward, and what considerations ultimately led them to choose one particular mortgage over another—proof that underwriting guidelines help borrowers and hinder lenders from stumbling into mortgages that are excessively risky.

Freddie Mac's approach to ARM's is the same as our approach to a fixed rate mortgage. Very simply, no home buyer wants to lose his or her home, and no lender or investor wants to own it by default.

UNDERWRITING GUIDELINES

We are very proud to provide for the record a copy of Freddie Mac's ARM's underwriting guides, which were the first nationwide set of criteria reflecting the fact that ARM's are different from fixed rate mortgages.

Lenders are encouraged to adopt these guidelines for all ARM loans, to provide a prudent mortgage to borrowers over the term of the loan, and to ensure the quality standards desired by investors.

The thrusts of the guidelines are as follows:

First, the borrower's ability to pay the loan must be carefully analyzed in terms of the impact of potential rate changes over time, not only the initial rate.

Second, loans with high loan-to-value ratios, say those over 90 percent, need more conservative underwriting to ensure more safety.

Third, the appraisal process needs to be strengthened to account for financing concessions or volume.

Fourth, the private mortgage insurers should be gathering accurate data to monitor ARM's performance. Freddie Mac initiated data gathering requirements for these insurers as part of our ongoing review to ensure the financial stability of the firms on our approved mortgage insurance list and to develop the first detailed base of information about which ARM's are safer than others.

Just as important is the fact that to the degree the mortgage insurers use Freddie Mac underwriting guidelines to establish criteria for ARM's that they insure, we have helped facilitate the safety and soundness of all ARM's, not just the ones we purchase.

Freddie Mac recognizes the difficulty of developing ARM's, which balance the varying interests—the borrower, the lender, the investor. It takes time to develop a quality investment vehicle that will attract investors and help generate additional mortgage credit, but we anticipate by later this year we will be able to put into the market a quality mortgage-backed security using a standardized ARM as its collateral.

Meanwhile, Freddie Mac will continue its research to create an ARM program that will be a model for the industry, just as Freddie Mac pioneered a sound conventional fixed rate mortgage for the industry in the 1970's.

I, too, will be happy to answer any questions.

[The complete prepared statement follows:]

STATEMENT OF

KENNETH J. THYGERSON
PRESIDENT AND CHIEF EXECUTIVE OFFICER
FEDERAL HOME LOAN MORTGAGE CORPORATION

INTRODUCTION

Mr. Chairman and distinguished Members of this Subcommittee. It is a pleasure to appear before you today to discuss adjustable rate mortgages, or "ARMs" as they are more commonly called.

The Federal Home Loan Mortgage Corporation, Freddie Mac, is a Congressionally-chartered corporation, owned by savings institutions across the nation, whose purpose is to increase the availability of conventional residential mortgage financing for homebuyers. Freddie Mac does so by purchasing mortgages from mortgage lenders across the nation and developing securities backed by mortgages that tap the capital markets. In order to link the capital markets with local mortgage markets, Freddie Mac has developed sound underwriting guidelines, standard mortgage documents, and mortgage-backed securities, all of which have become industry prototypes.

ARMs - EVOLVING IN THE MARKETPLACE

Mr. Chairman, I believe the Adjustable Rate Mortgage has been, and will continue to be, an important mortgage instrument for consumers and lenders. It is an option that will grow in importance with an expanding homebuying population. It will become an even more important option for the growing number of first time homebuyers who cannot afford large mortgage payments in their first years of homeownership, but can anticipate greater income growth in the future.

But ARMs represent only one of the important options for homebuyers. The 15-year mortgage is increasingly popular among middle-age homebuyers who don't want to be strapped with or pay for a long-term mortgage obligation as they move into retirement years and fixed or reduced income situations. And of course the 30-year fixed rate mortgage remains the backbone mortgage for a large proportion of the middle-income homebuying public.

We all recognize that there have been some uncomfortable growing pains over the past few years as ARMs were evolving. We have all heard stories about ARM underwriting practices that potentially subject ARM borrowers to unreasonable payment increase or decreases in their home equity. We also heard from borrowers who needed more and better information before choosing an ARM that fit their needs.

Similar hearings before your counterpart Subcommittee in the House last August helped those Subcommittee Members reach the conclusion that more uniform information on ARMs should be available to the public. The Subcommittee called upon the federal regulators and industry representatives, including Freddie Mac, to form a task force and develop a comprehensive public information brochure on ARMs with one consistent set of terms. That brochure was published this past January and has been widely distributed across the country through lenders and realtors. This task force brochure has been instrumental in educating borrowers, realtors and lenders on ARMs.

In addition, lenders' approaches to ARMs have matured as a result of the guidance offered by the Congress, from their own experience and from industry leadership, and they have moved forward in adopting uniform and sound underwriting guidelines.

The development of ARMs has clearly shown that financing the nation's housing needs is an evolving process that requires compromise, flexibility and continued improvement.

ROLE OF FREDDIE MAC

The role of Freddie Mac in the marketplace has, over time, significantly enhanced the investment characteristics of fixed-rate single-family and multifamily mortgages, thereby broadening the base of home mortgage credit. The corporation is trying to assist the development of ARMs in a similar way. In this effort, we continue to be guided by our federal charter, by our public purpose origins, and by the operating policies established by our Board of Directors to broaden the availability and affordability of mortgage credit for America's homebuying public.

Just as in the case of the fixed-rate mortgage, Freddie Mac's ARM development efforts reflect statutory requirements concerning the kind and quality of mortgages eligible for purchase by the corporation. For when Congress created Freddie Mac, it made clear that the corporation could only purchase mortgages "of such quality, type, and class as to meet generally the purchase standard imposed by private institutional mortgage investors". This requirement has proven crucial to our ability to expand the investor base for mortgage products.

Freddie Mac is also guided in its program design by its Congressional mandate to provide leadership in mortgage finance. This means that programs be designed--consistent with our role in the marketplace--that take into account the needs of consumers, lenders, investors, and the housing finance system as a whole. Our obligation is not simply to purchase what is already available in the marketplace, but to evaluate needs and develop programs to address these needs.

As a result, Freddie Mac has carefully studied the evolving ARMs market to decide which ARMs meet our investment quality standards. We have tried to formulate mortgage purchase programs that will generate sufficient volume to permit the issuance of securities backed by those mortgages. But we have been hampered by a lack of standardization in the market and so have attempted to facilitate that standardization in a variety of ways. For example, Freddie Mac has prepared publications on what makes ARMs successful. The corporation is working with others in the industry to develop ARM underwriting guidelines which will be used industry-wide. Additionally, Freddie Mac is developing interest rate and payment capped programs which have widespread appeal to homebuyers and to lenders.

As I said earlier in my testimony, the ARM has been evolving for several years, experiencing growing pains in its consumer acceptance along the way. Our original ARM underwriting guidelines reflected our first attempt at standardizing the ARM market, providing guidance in making the ARM an acceptable mortgage alternative that can better benefit lenders and consumers alike. Our new guidelines include what we learned in our first attempt at standardization, and are the result of careful research, and many industry and consumer discussions.

We also increased our understanding of investor needs. It takes time to develop a quality investment vehicle that will attract investors and help generate additional mortgage credit. We anticipate finalizing a quality mortgage security backed by ARMs this summer.

It is not our role, as a secondary mortgage market conduit, to be a portfolio lender and take on unnecessary interest rate risk. Rather, our role is to ensure that the mortgages we purchase are of such quality that they can back the securities we sell to investors. The higher the quality - and standardization - the greater the volume. Standardization and investors' confidence in the quality of ARMs means a better price for the securities we sell. It also means we can buy the mortgages from lenders at a better price which ultimately results in more money in the mortgage market at better rates for borrowers. Freddie Mac's role translates into a set of operating objectives for program design that include four essential criteria:

- First, home mortgage loans should be soundly underwritten. As I mentioned earlier, Freddie Mac's consistent approach to ARMs is the same as our approach to the fixed-rate mortgage underwriting is critical. No homeowner wants to lose his or her home, and no lender or investor wants to own it by default. Our ARM underwriting guidelines were the first industry-wide effort at establishing underwriting standards to reflect the fundamental differences between ARMs and fixed rate mortgages.

- Second, standardization of ARMs will help consumers to shop wisely and aid in the development of a secondary market. Our ARM guidelines are a direct result of our commitment to standardization. Too much advertising can be expensive and unattractive to investors as well as confusing for consumers.

- Third, program design should be supported by ongoing research. The issues facing borrowers and lenders associated with home mortgage lending can shift dramatically in the volatile environment in which we now live.

- Fourth, the risk associated with the home mortgage lending process should be continuously monitored and evaluated. The evolution of our ARM guidelines reflect this type of monitoring and evaluating.

Let me now say a few words about how these objectives are translated into Freddie Mac actions to help consumers.

SOUND UNDERWRITING

Sound underwriting is the key requirement to keeping homeowners in their homes and providing investment quality loans to investors. Freddie Mac established uniform underwriting guidelines for 30-year fixed-rate mortgages that have become the industry standard. These have been very successful; only about 1 homeowner in 500 whose conventional loan has been sold to Freddie Mac has gone into foreclosure -- well below the industry average.

The challenge of developing sound underwriting guidelines for ARMs in the 1980s was just as important as the guidelines developed for conventional fixed-rate mortgages in the 1970s. Freddie Mac accepted this challenge, and took the lead in developing sound ARM underwriting standards which help protect borrowers as well as lenders from excessive risk. And just as uniform underwriting guidelines for conventional fixed-rate mortgages took some time to develop in the 1970s, the ARM guidelines first suggested some months ago will be continuously re-evaluated as the ARM market matures.

When Freddie Mac introduced its ARM underwriting guidelines in August 1984, the first set of nationwide standards to be put forth, we made them very stringent in order to send a message about the importance of proper underwriting to the market. At the time, we recognized that strict adherence to the guidelines would reduce the attractiveness of ARMs to both borrowers and lenders, by limiting their usefulness in qualifying borrowers at rates below fixed-rate levels and their use by lenders for portfolio restructuring. In 1985 Freddie Mac decided to modify its underwriting guidelines to allow more flexibility in ARM design while continuing to emphasize prudent risk management, taking into account the need to balance the goals of affordability and minimization of credit risk. The recent positive market trend towards capped ARMs without deep initial discounts provides borrowers with less risky instruments.

Attached to this statement is a copy of the underwriting guidelines for investment quality ARM loans approved by Freddie Mac's Board of Directors. Lenders are encouraged to adopt these guidelines for all ARM loans to provide a prudent mortgage for borrowers over the term of the loan, and also ensure the quality standards desired by investors.

The thrust of our guidelines is as follows:

1) The borrower's ability to pay the loan must be carefully analyzed in terms of the impact of rate changes over time, not only by the initial rate. As a result, the income criteria used in underwriting should be adjusted to reflect potential payment adjustments and the possibility of negative amortization.

2) Loans with high loan-to-value ratios (over 90%) need more conservative underwriting to ensure more safety.

3) The appraisal process needs to be strengthened to account for financing concessions.

4) The private mortgage insurers should by gathering accurate data to monitor ARM performance. We have required them to collect the data as part of our ongoing review to ensure the financial stability of the firms on our approved list. I will elaborate on this important issue later in my statement.

STANDARDIZATION

Just as Freddie Mac has provided standardization in the marketplace for 30 year fixed-rate loans, we now intend to establish standards for ARMs both in terms of documentation and product design. First, Freddie Mac has worked with Fannie Mae to standardize and put in plain language the mortgage documents on which ARMs are originated. This standardization will permit a lender to deliver one of these loans to either organization, and to most private sector secondary market firms, at any time. More important, this standardization will simplify ARMs for borrowers as well as lenders, facilitate secondary market trading and reduce mortgage costs over time.

Second, we have attempted to provide the same standardization to the design of ARM instruments, which should help to minimize borrower confusion. All but one of our programs use Treasury rates as indices. Other than the index and the frequency of adjustment (we offer 3 and 5 year rate change programs, as well as programs for loans with annual rate changes), our purchase programs give borrowers a choice as to the degree of interest rate and payment protection they desire. Our programs offer the choice between payment caps (7½ percent annual) only, payment caps combined with a 5 percent life of loan cap (set on the fully-indexed note rate on the mortgages) or the 5 percent life cap combined with either 1 percent or 2 percent annual limits on rate adjustments.

These programs differ as to the degree of protection against interest rate change they offer borrowers and, therefore, the degree of interest rate risk retained by lenders. We expect that loans with tighter interest rate caps will command higher rates in the market. Offering borrowers a range of options on the choice of a cap will allow considerable flexibility in designing a wider range of affordable mortgages suited to individual borrower and lender needs. These programs are designed to better balance the risk of interest rate fluctuations for the homebuyer and lender. They will provide borrowers with more uniform products when choosing a mortgage, while helping lenders increase the liquidity of their assets.

RESEARCH

In order to help consumers find investment quality ARMs, Freddie Mac has fostered research on a wide variety of issues relating to the ARM.

One very important issue is consumer awareness and understanding of the terms and risks associated with mortgage loans. In preparing our ARM programs, Freddie Mac conducted consumer focus groups to evaluate homebuyers' knowledge and understanding of the mortgages they chose. I personally attended one of these groups and learned much more about how homebuyers search for information, about the different types of mortgage financing available, how they evaluate the risks they face should mortgage rates adjust upward, and the considerations that led them to choose the particular mortgage they did.

The consumer guide that I mentioned earlier, as well as other ARMs guides produced by the housing industry, have been instrumental in educating homebuyers on ARMs. Freddie Mac had substantial input into the formulation of these guides which outline in plain language such unfamiliar terms as "discount loans," "negative amortization," "payment and interest rate caps," and "payment shock."

Ongoing research is being conducted to ensure that ARM underwriting, pricing and borrower disclosure are sound in a volatile financial environment. Freddie Mac has undertaken a variety of studies on ARM program design and pricing, and sponsored several workshops to facilitate discussion of the credit risk issue.

We have learned and will continue to learn from our ARMs experience. As we do, we will continue to be responsive to homebuyers' and their lenders' needs. As a consequence, we have maintained our major information dissemination effort. We will continue to write widely on this topic, arrange meetings with industry officials to discuss the issues and attend meetings arranged by other outside organizations.

MONITORING AND EVALUATING

Freddie Mac puts it own guarantee, not backed by the full faith and credit of the U.S. government, on top of the insurance provided by private mortgage insurers ("MIs"). This guarantee is the key to our role as market maker, and the mortgage insurance industry is a necessary ingredient to investment quality for some loans. This system of guarantees has served the market very well. However, it can only work if the mortgage insurers can pay claims.

Freddie Mac takes very seriously the responsibility regarding the financial solidity of the MI. The corporation has been especially encouraged by the responsiveness of this industry to the concerns over the quality of the ARMs they have insured.

Freddie Mac sets eligibility criteria for the mortgage insurance industry and monitors them closely, particularly with ARMs. Mortgage insurers must file detailed quarterly and annual financial reports so that we can analyze their ability to pay such claims. We now require that private mortgage insurers collect more ARM loan information from lenders, and, eventually, they provide us with quarterly reports on this information. This information will be used in Freddie Mac's review of a private mortgage insurer's financial stability and is factored into the decision as to whether to maintain that firm on our approved list.

This unique data base on ARMs should be helpful to the Congress, financial institution regulators, and others concerned with the program, the design, servicing and foreclosure experience with ARMs. It will allow us to obtain up-to-date information on ARM delinquencies by program type which will facilitate review and modification of underwriting guidelines to ensure the safety of these loans for borrowers and lenders.

CURRENT DIRECTION

I cannot say if or when we will see the end of the ARMs evolution, or that we will ever finally develop the ultimate combination of features and underwriting requirements for ARMs. But this is what Freddie Mac has been working toward for well over two years. We have been refining our ARM underwriting guidelines and mortgage purchase programs to balance lender portfolio needs and borrower affordability and protection. It isn't a simple task.

Freddie Mac owns approximately 18,000 ARMs compared to almost 2 million single-family fixed-rate loans which we are currently servicing. We have had no hesitations about conceding temporarily market share and commitment volume in order to more carefully evaluate the market and move towards greater ARM standardization. That standardization will help to assure a handful of quality ARM products for lenders, homebuyers and investors alike instead of hundreds that only serve to confuse consumers and make ARMs less acceptable. Standardization takes time but we feel the market is moving in that direction.

Freddie Mac recognized the difficulty of developing the ARM which balances the interests of the borrower, the lender, and the investor. Nonetheless, our conviction is that these three parties do have in common the fact that just as no homeowner wants to lose a home, no lender or investor wants to own it. Freddie Mac will continue its research to ensure an ARM program structure that will be a model for the industry--just as Freddie Mac pioneered a sound, conventional fixed-rate mortgage for the industry in the 1970s.

UNDERWRITING ADJUSTABLE RATE MORTGAGES (ARMs) AND OTHER MORTGAGES WITH PAYMENT ADJUSTMENTS

Introduction

Adjustable rate mortgages (ARMs) are relatively new to borrowers, lenders, and investors. Because of their newness to the marketplace there has been considerable experimentation with program design, pricing, marketing, and underwriting practices.

Freddie Mac recognizes that the ARM is a valuable risk management tool for lenders and investors. ARMs also provide additional homeownership opportunities for consumers because the generally lower ARM rates qualify some borrowers who would not have qualified for fixed-rate financing. The premise underlying the introduction and widespread use of ARMs is that borrowers, on average, can absorb interest rate volatility because their incomes are likely to be growing and the value of their homes rising. But this shift in risk puts a much greater burden on the underwriting process. The purpose of underwriting guidelines is to benefit all parties by specifying reasonable bounds for this risk and eliminate unnecessary risks stemming from inappropriate instrument design. We recognize that the ARM marketplace is evolving, and further refinement of these underwriting guidelines will result from more experience with the instrument.

In developing the following guidelines, Freddie Mac analyzed input from a broad array of lenders and mortgage insurers. The guidelines are conservative, yet practical in addressing the needs of borrowers and ultimate investors.

These guidelines provide parameters that we consider acceptable for "investment quality" ARM loans. Individual Freddie Mac ARM programs may contain more limiting requirements, however, than those listed in these guidelines. The guidelines address only underwriting risk factors and do not attempt to assess how different types of loans fit into lender portfolio strategy. Lenders are encouraged to adopt the guidelines for all ARM loans to ensure the quality standards desired by investors and, most importantly, to provide a manageable and prudent mortgage instrument for borrowers over the term of the mortgage.

Comparison with Standard Level-Payment Fixed-Rate Mortgages

Some lenders are underwriting ARMs using the same criteria as for FRMs. The principles of FRM underwriting, such as the sound underwriting of credit and property value, still apply and are even more important for ARMs. Because there is possibly more inherent risk in an ARM than in an FRM, additional underwriting guidelines are necessary. The following guidelines are intended to provide flexibility in designing of ARM programs while simultaneously limiting the overall risk.

Mortgage actuaries have identified the two major reasons borrowers have defaulted on FRMs: insufficient equity in the property and a burdensome monthly payment in relation to income. Payment burden is an immediate cause of delinquency, but if there is substantial equity in a property, the borrower is more likely to sell the property and repay the mortgage than go to foreclosure.

The implications of this experience are straight-forward. With level-payment FRMs, changes in borrower payment burden have been principally due to changes in income. The underwriting process minimized risk by assessing long-run income prospects. The experience with FRMs over the last decade was that mortgage balances declined due to amortization while property values appreciated, resulting in a growing equity cushion for the average borrower.

Past experience with FRMs may be an inadequate guide to the determinants of default on ARMs. ARMs and graduated payment type mortgages (GPMs, buydowns) add new sources of change in payment burdens and/or equity. ARMs potentially subject borrowers to periodic mortgage payment adjustments when underlying indexes move or when initially discounted rates adjust to market. Payment burdens can therefore fluctuate due to changing payments as well as changing incomes. Underwriting guidelines must be based on the likelihood of payment changes and the amount of payment change that borrowers can accept in subsequent years of the loan. Therefore, underwriters must assess both the borrower's income and payments prospects.

ARMs may also lead to erosion in borrower equity. Many ARMs include provisions for a rising mortgage balance (negative amortization). When property values are appreciating slowly, this provision may reduce or eliminate the equity cushion. Underwriters must determine the likely changes in equity arising from both property value and variations and mortgage balance increases.

In addition, many lenders have reduced the income necessary to qualify borrowers by using initial rate discounts and GPM features. These practices increase the risk by potentially subjecting the borrower to larger payment increases or more rapid equity erosion than non-discount or non-GPM mortgages, and must be carefully controlled to avoid delinquency problems.

These underwriting guidelines focus on the additional risks of excessive payment burden and equity erosion with ARMs. The guidelines will address the following four areas: acceptable limits to periodic changes in mortgage payments; the appropriate rate at which to qualify mortgage borrowers; the affordability ratios, or the ratios of total monthly housing expense-to-gross income and total monthly debt payment-to-income, to be used when certain features are contained in the mortgage; and the maximum loan-to-value ratio that can be used for mortgages with negative amortization features.

Payment Adjustment Limitations

Lenders have used two different mechanisms to limit the magnitude of payment changes that occur with interest rate adjustments: interest rate caps and payment caps. The periodic interest rate cap sets a specific limit on the percentage the interest rate may increase or decrease at the adjustment date. Periodic interest rate caps generally apply at the

adjustment date of the mortgage. In addition, some mortgages limit the **aggregate increase** or decrease in rates over the life of the mortgage.

By limiting the magnitude of rate changes, periodic interest rate adjustment caps and life of loan rate caps limit the potential payment change, or payment shock, that can occur at adjustment. The interest rate cap feature, which shifts some of the interest rate risk back to the lender without potential for negative amortization, reduces default risk in ARMs.

Table 1 shows the maximum rate adjustments for various rate adjustment periods. Mortgages with maximum periodic rate adjustments that do not exceed these percentages are considered to have acceptable limits on payment adjustment. The periodic interest rate cap must apply during every adjustment period on the mortgage. The third column illustrates the amount of the monthly payment increases on a 30-year, $50,000 mortgage at a 12 percent interest rate with initial payments of $514.31. The calculation for each rate adjustment period is based on the minimum adjustment period.

Table 1
Guidelines for Periodic Interest Rate Caps

	Per Rate Adjustment Period	
Rate Adjustment Period	Maximum Rate Adjustment	Illustrative Maximum Payment Increase
Less than 6 months	0.167%	$ 6.43
6 months or more but less than 1 year	1.0%	$ 38.79
1 year or more but less than 2 years	2.0%	$ 78.12
2 years or more but less than 3 years	3.0%	$ 117.91
3 years or more	5.0%	$ 198.53

Another mechanism that limits the magnitude of payment changes is the payment cap. A payment cap, usually exercised at the borrower's option, limits the amount of change in the monthly principal and interest payment at the time of adjustment. Payment caps simply defer payment of additional interest resulting from increases in the interest rates. This unpaid interest is frequently added to the outstanding principal. The deferred interest, or negative amortization, leads to increase in the amount owed and, therefore, potential erosion in the borrower's equity. Because both payment burden and equity erosion are important determinants of default, the payment capped instrument attempts to limit total default risk by striking a balance between these factors. Typically, this is done by recasting the mortgage when the mortgage balance reaches 125 percent of the original principal amount, and then prohibiting additional negative amortization.

ARM loans with the maximum payment adjustments shown on Table 2 are considered to have acceptable limitations on periodic payment adjustment. The potential payment burden is about the same for these payment capped ARMs as for the interest rate capped ARMs in Table 1. Payment capped ARMs have the additional potential for negative amortization and borrower equity erosion, however with these limits the magnitude of equity erosion is not very large. Table 2 shows the maximum payment adjustment for various payment adjustment periods. The third column shows the increase in payments of a 30-year, $50,000 mortgage at [illegible] percent interest with initial payments of $514.31.

Table 2
Payment Adjustment Guidelines

Payment Adjustment Period	Per Rate Adjustment Period Maximum Cumulative Payment Adjustment	Illustrative Maximum Monthly Payment Increase
Less than 6 months	1.25%	$ 6.43
6 months or more but less than 1 year	7.5%	$ 38.57
1 year or more but less than 2 years	15.0%	$ 77.15
2 years or more but less than 3 years	22.5%	$ 115.72
3 years or more	37.5%	$ 192.86

Qualifications and Discounts

Some ARMs have initial interest rate discounts, or subsidy buydowns. A discounted mortgage loan is one in which the borrower pays less than the fully indexed note rate prior to the first interest rate adjustment. Mortgages with a subsidy buydown reduce the borrower's initial rate by payment of funds in advance. The probability that payment shock will occur is increased because such mortgages require some increase in payment even if there is no change in the value of the index, and may lead to larger payment increases than implied by underlying rate changes. Moreover, initial rate discounts and subsidy buydowns have been used to increase the attractiveness of ARMs for some borrowers who have trouble qualifying for financing at higher interest rates. These mortgages are thus inherently more risky than other mortgages already discussed, and must be underwritten more conservatively.

Borrowers can be qualified at the initial rate as much as 200 basis points below index-plus-margin when the loan-to-value (LTV) is 90 percent or less. When ARMs exceed 90 percent LTV with either a periodic rate cap exceeding one percent, or a periodic payment cap with potential negative amortization, they should be underwritten at the fully indexed note rate. In addition, any subsidy buydowns must have expired 12 months prior to the first adjustment date in order to avoid a possible payment shock resulting from a combination of factors. This qualification criterion addresses the need to balance the goals of affordability and minimize credit risk by permitting more flexibility in ARM design while continuing to emphasize prudent risk management.

Affordability Ratios

Lenders have traditionally qualified borrowers for mortgages by calculating the housing expense-to-income and total debt payment-to-income ratios based on borrower income at the time of application. With ARMs, these ratios are likely to change due to payment adjustments as well as changes in income. Mortgages with interest rate or payment caps falling within the guidelines outlined in Tables 1 and 2 provide acceptable limits to the changes in these ratios due to mortgage payment changes. Therefore, such ARMs with such caps and without any of the features or combinations of features specified in Table 3 can be underwritten using the same income criteria as 30-year FRMs, allowing an initial ratio of total monthly housing expense-to-gross income up to 28 percent and a total monthly debt payment-to-income ratio up to 36 percent.

ARMs with the following features should be underwritten at 25 percent and 33 percent ratios:

- Periodic rate or payment caps outside the guidelines, including no caps
- Initial period discounts exceeding the guidelines
- Initial LTVs over 90 percent with a periodic rate cap exceeding 1 percent, or a periodic payment cap exceeding 7.50 percent.

- Rate and payment adjustment periods occuring more than 3 years apart without payment caps inside the guidelines of Table 2.

ARMs that contain such features may increase the likelihood that payments and affordability ratios will rise relative to mortgages without these features. ARMs with no caps or caps outside the guidelines have the potential for large increases in the ratios. Therefore, they should be underwritten at the lower ratios of 25 percent monthly housing expense-to-income and 33 percent total monthly debt payment-to-income. Likewise, mortgages with discounts or subsidy buydowns in excess of 2 percent increase the potential for significant payment shock and should be underwritten at the 25/33 ratios. Finally, on mortgages with differences in rate and payment adjustments over three years, payment shock can occur even if the periodic rate caps are inside the guidelines. For example, if rates adjust only 2 percent per year for 5 years, payments adjusting to the fully amortizing amount in the fifth year would exceed the guidelines in Table 1. Therefore, these loans should be underwritten at 25/33.

Loan-to-Value Limitations

When negative amortization features are added to ARMs, there is a potential for equity erosion. Negative amortization can result from large initial rate discounts (over 2 percent) in combination with payment caps, GPM features, or differences in periodic rate and payment adjustments (over 3 years) as provided in the note. Because the nagative amortization build-up in these mortgages can be significant, they should be underwritten at a maximum loan-to-value ratio of 90 percent (Table 3). The additional equity cushion is necessary to offset the negative amortization that can occur with these mortgages.

Table 3
Maximum Loan-to-Value Ratios

ARMs without the features listed below can be underwritten at a maximum loan-to value ratio of 95 percent. Otherwise the following limitations apply.

Feature Combination	Maximum Loan-to-Value Ratio
Graduated payment feature	90%
Discount or buydown greater than 2% and payment caps	90%
Differences in rate and payment adjustments over 3 years	90%

Caps on Negative Amortization

A related issue is the maximum amount of negative amortization allowable on the mortgage. Negative amortization becomes more important at higher initial loan-to-value ratios. The current industry practice is to limit the unpaid principal balance to 125 percent of the initial mortgage amount. Another approach is to set the limit at 100 percent of the initial appraised value. This allows borrowers who make larger down payments to have lower monthly payments for a longer period of time. Either approach is a generally acceptable underwriting practice.

Fixed Rate Graduated Payment Mortgages (FRGPMs)

Fixed-rate Graduated Payment Mortgages provide for lower initial monthly payments than standard FRMs. The lower mortgage payments during the early years do not fully cover interest and amortization; thus creating negative amortization even though there is no change in the interest rate. After the graduation period, the payment is adjusted so that the mortgage balance is amortized over the remaining term. The scheduled payment increases and negative amortization dictate that FRGPMs should be underwritten with greater care than FRMs. Therefore, lenders should limit the maximum LTV of FRGPMs to 90 percent, and the maximum annual scheduled payment increase to 7.5 percent.

Lenders whose programs meet the 90 percent LTV and 7.5 percent payment increase guidelines can qualify borrowers at the initial payment rate and underwrite FRGPMs allowing an initial ratio of total monthly housing expense-to-gross income up to 28 percent and a total monthly debt payment-to-income ratio up to 36 percent.

Concluding Comments

Because mortgages with payment adjustments introduce additional elements of risk to mortgage lending, lenders should strictly adhere to all underwriting guidelines. This applies in particular to the underwriter's consideration of the appraisal and to exceptions to the guidelines for special borrower circumstances.

The appraisal report must accurately reflect an estimate of the true value of the property. Discount points, buydowns, or other special sales and financing concessions must be clearly identified and their effect on the value of the property must be analyzed and fully explained. When underwriting mortgages with payment adjustments, the underwriter must carefully review the appraisal report to determine if the appraiser has performed this analysis satisfactorily. If not, the appraisal should be considered deficient. The underwriter should consider netting the value of the favorable financing out of the appraised value in determining the maximum mortgage for a given loan-to-value ratio. In addition, a thorough analysis of the marketability of the property must be conducted on mortgages with possible negative amortization.

Exceptions to the underwriting guidelines for mortgages with payment adjustments should be granted only for very special borrower circumstances. Higher underwriting ratios should be permitted only when the following exist: 1) a verified cash down payment in excess of 30 percent of the appraised value; or 2) verified increases in the borrower's future income that would place the future ratios within the guidelines, assuming no change in the index value after the date of mortgage application; 3) or for energy efficient properties, verified savings in energy costs sufficient to offset the higher housing expense and debt payment ratios.

Senator **Gorton**. Before we begin questions, are there any opening statements from members of the committee?

Senator **Cranston**. I have an opening statement. I will put it in the record.

Senator **Gorton**. We will be delighted to.

STATEMENT OF SENATOR CRANSTON

Senator **Cranston**. The purpose of these hearings is to gather information on the use of adjustable rate mortgages. A recent study by housing markets released by the mortgage banking firm of Lomas & Nettleton found that more people could afford to buy new homes last year than at any time since 1978. According to the latest issue of Builder Magazine put out by the National Association of Homebuilders, "last year's rise in home affordability was in part due to the growth in the use of adjustable rate mortgages by consumers." ARM's have helped thousands of persons become homeowners particularly during adverse interest rate cycles.

In fact the development of these instruments was a response to the high rate of inflation in the 1970's and the concurrent deregulation of depository institutions liabilities that trapped many lenders between increasingly higher cost of borrowing new funds and the fixed lower rate earnings on existing long-term mortgage obligations.

State-chartered thrifts in California have been offering interest rate sensitive mortgage instruments since 1971, long before federally chartered thrifts.

The ARM market in California has been particularly large because the housing affordability problem has been greater in my State than in the rest of the country. The adjustable rate mortgage has been a contributing factor to the ongoing strength in home sales and new construction in California. These mortgages have not only been helpful to consumers but to lenders as well.

As one of the members of this committee who early on supported the nationwide use of adjustable rate mortgages, I look forward to hearing from the witnesses on how this mortgage instrument is working.

Senator **Gorton**. Mr. Maxwell, in the early years of adjustable rate mortgages, Fannie Mae purchased over 200 different kinds of those mortgages, before the time at which you required that they contain interest rate caps, payment caps, or both.

LOAN DEFAULT

Have you had a different loan default or delinquency experience with these early adjustable rate mortgages?

Mr. **Maxwell**. Mr. Chairman, I think, respectfully, that the 200 figure may be a little bit high. My figure is about 120. But I suppose when you get up in those areas it doesn't make a great deal of difference.

I would like to say first the reason why we did that because I think it is terribly important, and I think some of the other witnesses that you will hear from can bear this out.

In the dark days of 1981 and 1982, when the housing market was practically on its back, Fannie Mae provided a market for a large number of different kinds of adjustable rate mortgages which lenders and builders throughout the country felt were suited to their local conditions in order to qualify buyers for their homes. One of the most gratifying things that has happened to me since I got this job is to go around the country and have builders say to me that they would not be in business today were it not for the fact that Fannie Mae was willing to provide a market for these adjustable rate mortgages.

As far as the quality of those mortgages is concerned, we have a very minimal percentage of so-called teaser loans; that is, loans in which the initial rates were too low and there were no payment caps or interest rate caps on those mortgages. Our delinquency experience on those adjustable rate mortgages has largely been good.

The one instrument that we had found last year where we were getting a larger delinquency rate than we thought was wise was on the graduated payment adjustable rate mortgage, where the payments would be lower in the initial years and then graduated upwards in addition to any discount that was available. As a result, we tightened our underwriting guidelines for these particular types of mortgages.

So I would say, in summary, that the delinquency rate on adjustable rate mortgages is running about the same as our total portfolio, but the delinquency rate on the much smaller amount of graduated payment adjustable rate mortgages is somewhat higher. As a result, we needed to respond to that and tighten our underwriting guidelines.

Of course, now we don't buy an adjustable rate mortgage that doesn't have a payment cap or an interest rate cap on the mortgage.

Senator Gorton. You implied that you kept a number of builders in existence in 1981 and 1982 by buying all kinds of mortgages of this sort.

Is that an implication that if we should fall back into the economic times of those sorts, that you would have to lift some of the restrictions you proposed?

Mr. Maxwell. Well, what occurred at that time—and, of course, I suppose the witness from the National Association of Home Builders is more qualified than I am to talk about that—what occurred at that time was that the adjustable rate mortgage was just developing. It was a brand new product, and builders came up with all kinds of innovative ways that they felt could move their inventory in the face of extraordinarily high interest rates.

We believe that Fannie Mae's mission is to provide liquidity to the housing market, and that our countercyclical role that we were created for necessitated our being responsive to builders.

I would say that if we entered another period—God forbid—that was like 1982, the adjustable rate mortgage has been much more standardized since that time, people have gotten much more used to dealing with it, and I would not expect to have that large variety, nor would I expect necessarily that we would have to, as you put it, lift the restrictions.

I think the fact that the yield curve, for example, right now is as steep as it is enables a large number of home buyers to qualify, using adjustable rate mortgages, that could not qualify with fixed rate mortgages. They could qualify legitimately, with sound underwriting guidelines, such as Mr. Thygerson has described, in order to make sure that they can adequately meet the payments that they will confront in the future.

Senator **Gorton**. For you or either of the other members of the panel, are there difficulties—and if so, what kind—involved in turning adjustable rate mortgages into mortgage-backed securities or using them for collateralized mortgage obligations?

Mr. **Maxwell**. My colleague, Mr. Thygerson, should comment. Let me just say briefly, I think the interests of the investor and the interests of the home buyer are somewhat at odds in that situation. We have payment caps and interest rate caps on all our adjustable rate mortgages. Investors, at least the ones I have talked to on Wall Street, are very reluctant to accept that kind of limitation on the possibility of return, assuming that interest rates were to rise to levels like 1982, and this presents a very hard problem to solve in designing an adjustable rate mortgage-backed security, in my view.

Ms. **Fairbanks**. We have recently put together a number of teams to look at some of the problems in securitizing ARM's. It has just been interesting to me to hear comments. What David is saying is right. The investment community certainly doesn't like the look of the ARM when it is put into any kind of securitized form.

But I remember the concerns the investment community was expressing back when we first were trying to securitize fixed rate mortgages, and I will say that those problems were overcome. I am not so sure that these aren't similar concerns that can be dealt with.

Mr. **Maxwell**. I just wanted to add that we actually have issued an adjustable rate mortgage security to Home Savings of America which sold very well and also some variable rate mortgages from California from various lenders. But these were very special deals where the securities were privately placed, and I assume your question has to do with the liquid market, like the current mortgage-backed securities market.

VIABLE MORTGAGE-BACKED SECURITIES

Mr. **Thygerson**. I guess I am the optimist among the three, the most optimistic. The characteristics that are needed to put together a viable mortgage-backed security are basically standardization, a fairly high volume of that product—we call them products; they are actually mortgages—a very high volume of those mortgages being originated in the marketplace, confidence by the investor that those mortgages are underwritten prudently—a situation which was not true 1 year ago—and then, finally, a mortgage that has the pricing characteristics so that you can properly price some very difficult options to deal with payment caps, annual adjustment caps, among other things. That is a very difficult thing for investors to analyze.

What we now have, I think, in the marketplace is much more uniformity for the design of the product. We are getting a much higher volume of that product. The underwriting issues that were so prevalent 1 year ago have been substantially cleared up, and we are seeing these instruments priced much more competitively; that is, the buydowns. Some of the things that investors didn't want to see have gone away.

So, we are fairly convinced that by the end of this year we will have a very viable mortgage-backed securities program which will provide a ready source of institutional money as well as thrift money and Fannie Mae and Freddie Mac money to this marketplace, and I think that is a benefit to us all.

Senator GORTON. To you, Mr. Thygerson, Freddie Mac's underwriting guidelines caused quite a stir when they were first issued, with at least some industry officials saying that you were being high-handed. Under that first set of guidelines, you would not have purchased some of the most popular types of ARM's with a 2-percent annual cap or a 5-percent life-of-the-loan cap.

Have you eased up on those guidelines, and why were they more stringent?

Mr. THYGERSON. We looked at the market conditions of 1 year ago, and it was our assessment, based on analyses that we had done as to what kinds of payment adjustments most consumers—average consumers—would be able to tolerate, given various rates of inflation, income growth situations, and so forth. We also looked at the high prevalence, or certainly higher prevalence, of teaser rates, buydowns, whatever you want to call them, financing concessions.

The combination of these issues led us to try, in part, to make a statement, to provide leadership. By making a statement through these more conservative guidelines, as you indicated—in some quarters they were perceived as overly conservative—we got a great deal of attention addressed to this issue. As a result of that, we got a lot of people who weren't talking to begin to talk. They began to meet; they began to focus on these issues.

We then came out with some revisions to those guidelines in January or February of this year which seems to be the middle ground we were looking for.

One of the things that is true about underwriting is that it is not a static science. It changes with economic conditions. It changes as products develop, new types of mortgages are created.

We have changed our single-family underwriting criteria many, many times since they were first issued a number of years ago. I would expect that to be the case with ARM's as well. We have gone through now two iterations. I am not sure there will be more this year, but we have to anticipate changes of that nature.

Senator GORTON. Senator Proxmire.

Senator PROXMIRE. Thank you, Senator Gorton.

Mr. Maxwell, as I understand it, your organization, Fannie Mae, will not buy an ARM mortgage unless it has a 5 percent or less lifetime cap; is that right?

PAYMENT CAP

Mr. MAXWELL. Yes; unless it has a payment cap.

Senator PROXMIRE. What's the reason for that policy?

Mr. **Maxwell**. The reason for the policy, Senator Proxmire, is to provide protection both for the consumers so that the consumer will not get in over his or her head on the mortgage and also to improve the creditworthiness of the mortgage for Fannie Mae.

If the consumer is not in over his or her head, then it's likely they will be able to make the payments on the mortgage and won't go into default.

Senator **Proxmire**. So, on the grounds of safety and soundness, you consider it may be a less safe loan if it has a cap higher than 5 percent?

Mr. **Maxwell**. Yes, sir; I do.

Senator **Proxmire**. Why shouldn't we, on safety and soundness grounds, impose the same limit on savings and loans.

Mr. **Maxwell**. Well, I would defer to my copanelist here, Ms. Fairbanks.

Senator **Proxmire**. I want to ask her second, but I want to ask you first.

Mr. **Maxwell**. I guess, Senator, my answer to that would be that in the world which Congress is moving toward less regulation, I'm not sure that it seems appropriate to legislate that kind of cap. I assume when you said we you meant the Congress should impose that limitation on the savings and loans.

I'm not sure it would be appropriate to have legislation to that effect. I think it would be better if the industry were to adopt that and I believe that almost all lenders, have in fact, 5 percent caps.

Senator **Proxmire**. There are a whole series of areas of regulation. One area of regulation that seems to be the least controversial of all is safety and soundness. All of us agree we should take whatever action that seems necessary to provide a reasonable degree of safety and soundness so we won't have a financial institution fail.

Mr. **Maxwell**. I agree with that, Senator.

Senator **Proxmire**. And let me just interrupt you for a second.

On page 4, the very beginning of your statement, the second paragraph reads as follows:

> Nevertheless, even if unsound ARM's are rare, they should be corrected. The phrase, "A few rotton apples can spoil the barrel" is particularly apt. Many benefits of ARM's to borrowers, lenders, builders and realtors should not be ignored because some lenders want to book some fast fee income.

I think that's an excellent statement and it seems to me that principle would suggest to us that in order to protect the reputation of ARM's it would make sense to provide that kind of limit which, as you know, Senator Metzenbaum has proposed and he has considerable support, I understand, in the Senate.

Mr. **Maxwell**. Of course, from our point of view, the 5-percent cap is desirable, and it's up to the Congress in its wisdom to decide whether it should be legislated or whether it should be adopted by the industry.

Senator **Proxmire**. Now, Ms. Fairbanks.

Ms. **Fairbanks**. Thank you very much, Senator.

I would question whether a 5-percent cap if, in fact, the intent is safety and soundness, is going to accomplish that goal and I would urge us to remember the kind of interest rate fluctuations that we have lived through in the recent past.

I think from a safety and soundness standpoint, if I were to be concerned about the institutions, I would look to several things. No. 1, I would want to know that here was adequate supervisory control over the kind of underwriting guidelines applied to the individual borrower, those borrowers who don't have a 5-percent cap on their loan. If the institution is, in fact, giving adequate credit analysis to a borrower's potential to be able to pay and absorb any increase, then it may, in fact, be issuing a mortgage contract that is good for the borrower and also is good for the institution, permitting the institution not to be caught in a bind of holding a mortgage that doesn't fluctuate when interest rates may, in fact, go higher.

I would suggest that we had some early problems regarding the open-ended ability of institutions to issue mortgage contracts. However, I think there are recent supervisory guidelines that were put in place for taking supervisory action when the borrower's ability to pay hasn't been adequately demonstrated relative to the terms in the individual contract.

So, from the safety and soundness standpoint, I would urge that we continue to provide the institution flexibility to structure a sensible contract with the individual mortgage borrowers.

Senator **Proxmire**. Does the Home Loan Bank Board differ from Fannie Mae's position that a higher than 5-percent cap is likely to be an unsound basis for investment?

Ms. **Fairbanks**. I think that the Bank Board believes very strongly in individual mortgage contracts negotiated with individual mortgage borrowers. If the borrower has the ability to absorb rate increases, then the contract should, in fact, be able to reflect the kind of risk being absorbed both by the institution and the borrower.

Senator **Proxmire**. Let me ask you, Mr. Thygerson, if Congress were to enact a statutory 5-percent lifetime cap on adjustable rate mortgages as in the Metzenbaum amendment, wouldn't that help increase consumer confidence in ARM's and avoid a few lenders giving them a bad name with teaser rates?

Mr. **Thygerson**. It may. I don't perceive right now that there are serious concerns among consumers about adjustable rate mortgages. I think we've had 2½ or 3 years of experience. As recently as 6 months ago, almost two-thirds of all ARM's were being made by the thrift industry which means that the majority of borrowers would use the adjustable rate mortgage.

I believe that you can design an adjustable rate mortgage that is prudent and safe that doesn't include a 5-percent cap. I think that the experience that we've seen in California, particularly, with the design they've come up with—the use of the monthly cost-of-funds index of the Federal Home Loan Bank Eleventh District—they don't, in many cases, have caps, but they do have rather stringent safeguards relative to the amount of payment adjustment that occurs from one year to another, that influences the borrower.

They've also been very prudent in their underwriting with respect to loan-to-value ratios. So, I think you can design a prudent product. We have put out a product of that type and are willing to purchase it.

Senator PROXMIRE. Do you think Fannie Mae is being overly cautious? Do you think they have a wise policy? It seems to me it makes good, prudent sense. If it does for them, why shouldn't it be proper for the industry?

Mr. THYGERSON. I'm not saying at all that they're being overly cautious. All I'm saying is that you can design programs that maybe don't use a Treasury index like the ones that I think most of Fannie Mae's programs include. That can be prudently designed. They're probably just as safe as ARM's with 5 percent caps on them.

USE OF TEASER RATES

Senator PROXMIRE. Mr. Maxwell, would it make sense to prohibit teaser rates by some device that requires borrowers to qualify at the indexed rate or some other device?

Mr. MAXWELL. Well, I think that here again the regulator, in this case the Federal Home Loan Bank Board, should be concerned to make sure that the institutions that they regulate or that they have control over, do not use teaser rates.

The second part of what you said, Senator—if I understood it—I'm not sure that I would favor requiring that the indexed rate be used because it is very legitimate that the rate be brought down in the first year and that is a device that is extremely helpful to home buyers.

So I would not say that you needed to establish that a particular indexed rate is one that must be used, but I do think that the Bank Board could well look at the amount of shortfall below that rate that might be permitted.

Senator PROXMIRE. Well, I have a lot of faith in the Home Loan Bank Board, including Ms. Fairbanks.

Over the years, I think they've done a good job, but we have to be very, very concerned about safety and soundness. It's so important. The Ohio experience that we had was not related to the ARM's but, nevertheless, is an indication of what can happen. It seems to me it's much better for us to err on the side of caution rather than on the side of risk.

I see my time is up so I'll yield to the chairman.

Senator GORTON. Senator Cranston.

Senator CRANSTON. I'm delighted to have the chance to speak with all of you. I particularly welcome David Maxwell, whom I hope is still a Californian.

David, can you explain how 5 percent happened to be selected? Why not 7½ percent, which most California institutions apply, or some other figure; why 5 percent?

Mr. MAXWELL. There are two different types of caps, as Mr. Thygerson suggested. One of them is an interest rate cap and that maximum has been set at 5 percent. It could have been 6; it could have been 4 percent, but this seemed to be the most prudent figure to choose. I must say we're still in early days, as Mr. Thygerson said, with these types of mortgages and it may be that at some future time we would find that that was too high or too low. The 7½ percent that the California institutions use is a payment cap. It says that the payment of the borrower cannot rise more than 7½ percent from one year to the next.

The problem with payment caps can be that if interest rates spike up, you will get a large degree of negative amortization involved in the loan because what is not covered by the increase of 7½ percent payment, will be added to the loan balance. That's a danger to that kind of cap.

Senator **Cranston**. Isn't there an advantage to standardization of the ARM in terms of your ability to sell these in the secondary mortgage market. Is not that one reason that you have gone to the 5-percent cap?

Mr. **Maxwell**. Yes, sir. We are trying very hard along with Mr. Thygerson and others, to work toward as much standardization in the ARM market as possible.

Senator **Cranston**. So you have that provision in addition to whatever your views are on safety and soundness?

Mr. **Maxwell**. Yes, sir.

Senator **Cranston**. Senator Proxmire referred to a few lenders giving the industry a bad name and it seems that there are a few—got to zero in on them with a rifle shot with a regulation rather than just a broadside. Do you have any thoughts on how that might be done, Ms. Fairbanks?

STRENGTHENED SUPERVISION

Ms. **Fairbanks**. In fact, one of the things we have done over time is strengthen our supervisory procedures. I went back and asked our district banks for a compendium of the kinds of actions that had been taken and I will say that the complaints volume has been quite light.

I think it's a market that has been confused and in the early stages consumers weren't really aware what it was they should expect. We have, over the last 3 years, received only 378 consumer complaints which, when you think of the number of ARM's that had been written in that time, is really extraordinary.

That's not to say for those individuals that the experience they have had in those particular instances has not been painful. But as a result of seeing the evolution of this market, we have increased our supervisory controls. We issued a supervisory memorandum and our exam procedures now include review of all of the credit analysis behind the ARM's that are being written.

I think, in fact, that's probably our best way to handle this.

Senator **Cranston**. I think that's a good suggestion. It seems to me that the safety and soundness of the institutions, as well as consumer protection is a serious concern here.

I gather that safety and soundness of the entire industry was threatened when we had regulation Q limits and very high lending rates. Could not that actually contribute to the unsafety and unsoundness of the institution and, hence, the depositors under some circumstances?

Ms. **Fairbanks**. Absolutely. We had more limits in our early regulations when we first issued ARM's regulations in 1978 and then in 1980, and we progressively removed limits as our institutions started to engage in ARM's lending. We have recognized the kind of costs that we put on institutions if, in fact, they can't tie the rate of the contract that they are constructing with the individual mortgage borrower to the fluctuating cost of their funds.

Senator CRANSTON. The previous limits actually had many institutions in dire jeopardy; did they not?

Ms. FAIRBANKS. Yes.

Senator CRANSTON. What volume of consumer complaints do you see for ARM's?

Ms. FAIRBANKS. As I say, I went back 3 years and we've had 363 consumer complaints. I really was rather stunned when I saw the low number. I think, again, that does not mean there aren't some problems out there. For some reason, consumers are not coming forward. But I must say that I was surprised.

Senator CRANSTON. How many different forms of adjustable rate mortgages are there?

Ms. FAIRBANKS. Senator Cranston, I think what we have seen is increasing use of standardized products but we have still permitted our institutions to tailor individual mortgage contracts to the individual borrower's need. Ken Thygerson and Dave Maxwell can probably speak to the popularity of a couple of individual products.

Our institutions are issuing multiple kinds of loans.

Mr. MAXWELL. In your own State, Senator, as I think Mr. Thygerson said, the savings institutions use an index based on their cost of funds such as the Home Loan Bank of San Francisco. That is, of course, unique to that index. It's not used in Nebraska, or Kentucky, or some other place and it's not used by Fannie Mae.

So, there's all kinds of indices—they believe very strongly that that is the best thing, safest and soundest way for them to conduct business.

From Fannie Mae's point of view, since our borrowing in the capital markets relates to treasuries, it's much better to use the Treasury indexes. So this is just one variable that you find in the adjustable rate mortgage market.

Senator CRANSTON. One very important protection, obviously, for the investor and depositor, is truthful information about ARM's, so that informed decisions can be made. I know the three regulatory agencies have come up with a very good book on the adjustable rate mortgages. Do you think anything more is needed such as amending the Truth in Lending Act requirement, or do you think that adequate distribution of the booklet is sufficient?

Ms. FAIRBANKS. There is, in fact, further action underway. The Federal Home Loan Bank Board is working with the Federal Reserve. Under its Truth in Lending Act authority, the Federal Reserve is putting together a new regulatory amendment. That would apply to all mortgage lenders. I can't speak for the internal timetable, but my understanding is that perhaps some time in the next month or so, perhaps by the end of this month even, the Federal Reserve will be ready with this proposal.

Senator CRANSTON. Thank you.

Mr. Thygerson, do you have any comments?

Mr. THYGERSON. Only the one that dealt with the limit on how high these rates can go.

California has had a leadership position with the adjustable rate mortgage and was the first State to allow adjustable rate mortgages with one-half of 1 percent annual adjustment and a life of the loan adjustment of 2½ percent. As we later found out that simply was not enough. That may have been satisfactory based on previous inflation rates and previous interest rate volatility experience. But looking forward turned out to be inadequate so it's very hard to get those numbers.

Senator CRANSTON. Thank you, Mr. Chairman.

Senator GORTON. Senator Dodd.

Senator DODD. Thank you, Mr. Chairman. My apologies to you and to the panel for being a few minutes late this morning.

MORTGAGE STATISTICS

And you may have already gone over some of the points, but I am just curious, what are the average statistics on the consumer holding a mortgage? How do those numbers vary over the last, say, 25 years? Do you have any idea?

Mr. THYGERSON. There has probably been thousands of studies done on this, but the only generalization one can make about how long the average person keeps a mortgage really depends on what happens to interest rates.

Interest rates tend to go up over a long period of time. When they do people tend to hold their low-rate mortgages longer. As a result, the average loan life of those mortgages gets longer. If rates begin to come down, people refinance those mortgages quite rapidly, and the average life of those mortgages becomes lower.

Senator DODD. I understood that, the mobility question. I mean, this is a nation that is far more mobile than it has been in the past, is it not, and the idea of someone buying a family home and staying in it for 25 years, as my parents did, is far less likely today?

I have been in three homes in 12 years, obviously because of the job, although I suppose there are a lot of other jobs like that as well. You move around the country.

So what is happening in that regard?

The reason I ask is because we have taken a look at the variable rate mortgage with a cap on it, and you have just taken the maximum amount it could be, and what you are getting at the outset as a result of the ARM as opposed to the fixed rate mortgage, if you are getting a 5-year, the average consumers are staying in a residence 5 years before they have to move on to something else, and it actually comes out to me either as about the same or even a little bit less under the worst case scenario.

Mr. THYGERSON. I am with you now on that point. I think what we are seeing in the marketplace is what is called self-selection of mortgages; that is, a consumer that anticipates a 2-year stint in Washington or a move with their corporation that is likely to last 3 years, or a military job that may be 1 year, looks at the marketplace and says, "this mortgage gives me 3 years of protection, 5 years of protection; that is the one for me; if I can get that at a slightly lower rate going in, I can't lose."

In fact, consumers are pretty intelligent at selecting a mortgage. They can, in fact, make these kinds of decisions.

Senator DODD. Not only that, you get the guarantee of a cap.

Mr. THYGERSON. That is correct.

Mr. **Maxwell**. Senator, one of the differences now is that the conventional fixed rate mortgages are no longer assumable by the buyers; whereas, most adjustable rate mortgages—that we buy at any rate—are assumable. So they would run more with the property perhaps than they would the person who moves. So the adjustable rate mortgage might have a longer life these days than the fixed rate.

Senator **Dodd**. I can't remember where I saw this exactly, but about a number of these ARM's that don't have caps on them; 20 percent do not have?

Ms. **Fairbanks**. We are finding closer to 10 percent.

Senator **Dodd**. Do you have the number?

Ms. **Fairbanks**. Yes; 10 percent.

Senator **Dodd**. Is that because—are they being driven out because of competition? Is there any reason for us to do anything in that regard?

Ms. **Fairbanks**. The marketplace seems to be taking care of this without any intervention.

Senator **Dodd**. There has been talk of legislation of some kind that would require caps, but are you telling me there is no need for that because consumers are making those kind of choices anyway?

Ms. **Fairbanks**. I think, also, there has been a tremendous amount of publicity given to this issue, and you are seeing a great deal more caution on the part of individual mortgage lenders who may have decided in the past to do something that maybe wasn't as conscious of the consumer's interest. I would think there is a prophylactic effect by the use of aggressive and more stringent kinds of supervisory controls.

There is a reduction in uncapped loans, very clearly. Everyone has noted it, every survey that has been done, with the kind of alleged abuses that were prevalent in the development of this market and, as Ken says, there is a sorting out process as well.

Mr. **Maxwell**. I think you have raised a very good point, though. Competition does operate in the mortgage market, and consumers know they can go down the street and get a mortgage with a 5-percent cap right now. That is what they want because they like that sense of security.

That is why I believe that Ms. Fairbanks is correct in saying that 90 percent of the mortgages—I would say it might even be higher—of the adjustable rate mortgages now do have those caps.

Senator **Dodd**. The President of the United States always liked to cite specific examples to make his case, and I know a junior Senator from Connecticut who has a variable rate mortgage.

Senator **Gorton**. I know a senior Senator from Washington who avoided it. [Laughter.]

Senator **Dodd**. At any rate, it seems to be working in many areas.

BUDGET PROPOSALS

David, I am very tempted to ask you—we had David Stockman here the other day, and I understand we are here to be talking about variable rate mortgages, but Mr. Stockman was pretty tough on Fannie Mae the other day in his budget proposals.

Do you want to take a couple of minutes and just respond? I assume you have read his testimony or heard about it.

Mr. **Maxwell**. Yes.

Senator **Dodd**. I don't know if we are going to have a chance to see you up here before these things come up, but at least, if it is all right with you, Mr. Chairman, we could spare just a few minutes. We will not digress too much.

Senator **Gorton**. Certainly.

Mr. **Maxwell**. What I will try to do in a minute is to relate the question to the subject of this hearing.

In my testimony this morning, I pointed out the importance of the adjustable rate mortgages to Fannie Mae in reducing the risk that we inherited in 1981 of a large portfolio of low-yielding fixed rate mortgages and short-term debt which had to be turned over frequently to finance those mortgages. ARM's, which we need in order to match the assets and liabilities, have become an important part of our strategy, and we are up to about 14 percent of our portfolio; and obviously it is a long-term process.

But we pay for that because the yield that we get on those mortgages is lower than we could get if we just went on buying all fixed rate mortgages. But we are working at reducing the risk both to our stockholders and ultimately, I suppose, to the Government on our own, to work ourselves out of this problem.

I would only say that I think it is self-defeating and unwise for someone to propose, as Mr. Stockman is doing, that in the midst of this recovery program the Government should impose a tax on our borrowing, which will cost us a great deal of money and set back this self-help program in a very material way.

I have made those views known to the members of the Banking Committee, and I hope that the Senate will reject that proposal.

Senator **Dodd**. It is a reduced proposal from what was originally kicking around. I presume you are finding what has now been actually proposed to be far more appealing than what was being discussed as a possible option.

Mr. **Maxwell**. It is not far more appealing. It is less onerous. [Laughter.]

The change in the proposal is one on which we were not consulted, and it does not solve our problem. I do not think that this tax should be imposed on Fannie Mae because the only reason we have a borrowing advantage is that we are in one business, to provide liquidity in the secondary market.

When I was up here a couple of weeks ago, Senator Proxmire asked what I thought might be a fair way of doing this, if the Congress really was intent on imposing such a tax on us. I said you have got to give us a way of making some revenue to offset the payment of that tax because what you are doing is taking the liability side of the balance sheet and adding to that burden without any corresponding ability on the asset side of our balance sheet to make up for it. That is exactly what happened when S&L liabilities were deregulated, before they had the ability to buy adjustable rate mortgages and before they were given the flexible asset powers that they now have.

No one is suggesting that Fannie Mae receive such asset powers in return for paying its tax.

So I think that the proposal is wrong in its fundamentals, and the improvement of it—obviously, I am grateful for any movement. But that proposal as it now exists does not remove one of the most onerous aspects of this, which is its retroactive effect on Fannie Mae.

We have an enormous volume of debt to roll over, which relates to assets which were put into our books at fixed rates, which can't be changed. There are $46 billion of assets we purchased before 1981 that yield 9¼ percent, yet the debt that relates to those would be taxed.

Senator DODD. Let me just say again, that is not David Stockman's decision. That is our decision up here, and I couldn't agree more with you. Unless you can make an awfully good case for retroactivity on something, I have serious problems with it, and Members of Congress or members of the executive branch who introduce legislation are now saying that something becomes effective the day they introduce it. There is a certain amount of ego associated with it that I find appalling, or in the worst case they make it retroactive. That is something that 51 Senators and 218 House Members will decide, and the question of that added fee, which obviously you make a good case in response to.

Retroactivity is something that I suspect even people who may be sympathetic to what Mr. Stockman is saying in terms of trying to deal with larger issues such as the budget deficit—I think on retroactivity you will find far more sympathy than not.

The only other point I want to make is that there has been discussion over the past couple of years with regard to raising the cap of the market Fannie Mae can get into. Now, you got some credit operations, such as GE and others, who have been nervous about Fannie Mae, a quasi-governmental entity, encroaching on the private sector in that area.

Would that kind of raising that level offset the kind of burden you are suggesting, or are you really talking about more expanded powers rather than raising caps?

Mr. MAXWELL. Raising caps would be one of the ways in which we would have a larger market in which to earn more money to offset the tax. The proposal that we made would have simply raised the limit in high cost areas, as in California for example, where Fannie Mae and Freddie Mac really serve a lower part of the market than I think the Congress intended.

That raises the other point about the taxes being imposed, and that is the fact that the people, the institutions that are being asked to bear this burden, are the ones that serve the lower, moderate, and middle-income area of the market, and people that buy $200,000 homes aren't going to be affected by Mr. Stockman's proposal at all.

Senator DODD. I notice you called it a tax. He calls it a fee.

Mr. MAXWELL. It is a tax. It is an excise tax on our borrowing.

Senator DODD. I am making up a long list of euphemisms that I am going to use.

Mr. Chairman, my time has expired. I thank you, and I appreciate, David, your responding to the question that does move away somewhat from the subject.

Mr. MAXWELL. Thank you.

Senator GORTON. A number of members of the subcommittee, including the chairman, have additional questions, but in light of the fact that we have two more panels, we will simply submit them in writing.

[Response to written questions of Senator Gorton follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GORTON
FROM
SHANNON FAIRBANKS
FEDERAL HOME LOAN BANK BOARD

Question 1: One of the witnesses outlined the problem of the "double whammy." Under the "double whammy", lenders are collecting the full payment of a loan upon sale of a home, and also collecting a prepayment penalty. This situation exists because of a loophole in Bank Board regulations on due-on-sale clauses and prepayment penalties. The Bank Board finally published a clarifying regulation in December of 1984 to stop this abuse. However, the Board has twice put off finalizing this regulation. When will this regulation, which prohibits prepayment penalties in connection with due-on-sale clauses, be finalized?

Answer: Bank Board regulation 591.5(b)(2) currently prohibits lenders originating or holding real property loans from imposing "a prepayment penalty or equivalent fee for or in connection with acceleration of the loan by exercise of a due-on-sale clause" if the loan is "on the security of a home occupied by the borrower."

This prohibition applies only when a lender has actually "called" a loan by exercising the right of acceleration under a due-on-sale clause. Thus, borrowers who prepay loans in anticipation of due-on-sale acceleration may be charged prepayment penalties, while borrowers who structure the sales of their homes in a manner that compels lenders to enforce due-on-sale clauses may not be charged prepayment penalties. The exercise by some lenders of their contractual right to charge a penalty upon the prepayment of a home loan is popularly known as the "double whammy."

On August 10, 1984, the Board proposed to revise its regulation in response to Congressional concern for consumer protection and to the possible unfairness of permitting lenders which have not formally "called" a loan to achieve the same result by giving notice of an intent to do so and then charging a penalty upon prepayment. The proposed revision would prohibit prepayment penalties with respect to loans on the security of borrower-occupied homes if a lender (1) exercises a due-on-sale clause by written notice, (2) commences a foreclosure proceeding to enforce a due-on-sale clause or to see payment in full as a result of invoking such a clause, or (3) fails to consent within a reasonable time to the written request of a qualified purchaser to assume the loan in accordance with its terms, and thereafter the borrower sells or transfers the home to that purchaser and prepays the loan in full.

The Board initially provided for a thirty-day comment period ending on September 10, 1984, in order to expedite the rulemaking process. On November 29, 1984, the Board extended the comment period for sixty more days, through January 28, 1985, to permit a thorough formulation and evaluation of the issues being raised. The Board further notified the public that any final rule would become effective thirty days after publication in the Federal Register.

I appreciate that to some observers the Board must seem to be taking an inordinately long time to act upon the proposed revision to its prepayment-penalty rule. I respectfully suggest to you, however, that the Board could not have done otherwise. As you know, the matter is controversial. Furthermore, strong arguments have been presented on both sides of the question. Thus, the inability of the Board to act more quickly on the prepayment-penalty proposal should not be construed as evidence of a diminished commitment to bring to a conclusion this proposed rulemaking. Rather, the delay should be seen for what it is: the unavoidable result of the Board's determination to resolve as promptly as possible—but also as carefully and as fairly as possible—the issues surrounding the proposed rule. The Board has not yet decided how to resolve these issues, and I regret that I cannot predict when it will.

Question 2: Can you tell us what progress the Exam Council is making is formulating a standardized disclosure document for ARMs? Who will use this document?

Answer: Several working groups of staff studied the issue of standardized disclosure on adjustable-rate mortgages (ARMs) in conjunction with the Federal Financial Institutions Examination Council (FFIEC).

The standardization on the disclosure on ARMs will not, however, come from the FFIEC but through the Federal Reserve Board. As you know, the Federal Reserve Board has the rulemaking powers concerning implementation of the Truth-in-Lending Act. The Federal Reserve has recently proposed amendments to Regulation Z (Truth-in-Lending) that would significantly expand the scope of required disclosures on ARMs secured by the borrower's principal residence. The Federal Reserve has also proposed to delete Footnote 43 to Regulation Z. This Footnote allowed the Bank Board, Comptroller of the Currency, and the National Credit Union Administration to substitute their own ARM disclosure for that of the Federal Reserve. The practical effect of the elimination of Footnote 43 will be to standardize the disclosure for ARMs and to subject all lenders to the same disclosure requirements.

Question 3: How significantly have ARM's contributed to any improvement in the condition of the thrift industry?

Answer: Adjustable-rate mortgages improve the condition of the thrift industry by making it less susceptible to interest-rate cycles. Their role is not so much to improve current earnings as it is to reduce the variance of future earnings. It, of course, takes time for existing fixed-rate loans to roll off and be replaced by ARMs.

Substantial progress has been made. At the end of December, about 32 percent of the mortgage portfolio of FSLIC-insured institutions was adjustable rate. Also, about 50 percent of new loans have adjustable rates. The actual proportion of new loans put in portfolio with adjustable rates is higher than this because a significant proportion of fixed-rate production is sold in the secondary market.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GORTON FROM
DAVID O. MAXWELL

Q: Should Fannie Mae require more information on their appraisal forms, such as whether or not the comparables have a buydown?

A: Fannie Mae has joined with representatives of all segments of the housing finance industry to discuss the problems of mortgage credit quality. Lenders and others have expressed many different opinions on the causes for loan problems experienced in some markets, as well as possible solutions for these problems.

One suggestion is to require that appraisers use a cash equivalency value approach, i.e., that financing features like buydowns be eliminated when determining the actual value of a house. Advocates of this approach suggest that credit risk for new loans could be minimized by deducting financing concessions from the appraised value of a house. This would be an extremely difficult approach to implement, however, because there are practical problems in adjusting for the value of financing. However, the appraisal form includes a "check" by appraisers where they can note financing that may be unusual for that marketplace and adjust for it.

There are two intermediate alternatives to a strict cash equivalency value approach that we are reviewing, however. First, we could reduce the maximum loan-to-value on mortgages we purchase where there is a buydown in excess of a certain amount. Second, we could allow buydowns of a certain amount without requiring that the concessionary financing be taken into account in the appraisal. However, appraisals would have to be adjusted for buydowns exceeding that figure.

I suggested in a recent speech (copy attached) that broad-brush approaches to credit quality are like a doctor deciding on amputation when only selective surgery is necessary. I believe a preferable approach is to use the technological sophistication we now possess to control risk by paying far more attention to the details of underwriting and servicing performance. We can look at a set of variables, instead of a set of rules. We should tailor underwriting decisions and servicing performance evaluation to particular cases, as far as technology and our information base will allow.

I believe this approach will permit us to control risk more precisely, purchase soundly underwritten loans, and avoid any overreaction that could harm lenders, Realtors, builders or homebuyers. This approach will evolve over time and we will experience some fits and starts. But, it is the right way to deal with our customers and homebuyers.

Q: Why should not Fannie Mae have an "approved appraiser list" the way they have lists for approved lenders and insurers?

A: Fannie Mae once had an approved appraisers list. We discontinued it in 1981 to: (a) focus underwriting responsibility on lenders where it belongs; and, (b) streamline the underwriting process. We do not believe that reinstating an approved appraisers list would help us reduce credit risk. In fact, the opposite could occur because lenders might assume that if an appraiser was on our list, they would not have to monitor actual appraisals. Further, an approved appraisers list could be grossly misleading because there is just no way that Fannie Mae--at a wholesale level--can know the qualifications of appraisers all over the country.

Lenders are responsible for underwriting loans, subject to our guidelines. They know local appraisers best; we do not. Lenders should assure that appraisals are accurate. If certain appraisers do a sloppy job, lenders should not use those appraisers any more. And, we do sample appraisals to check their validity.

Appraisal of properties is an art and not a science, and is very much affected by local market conditions. We cannot possibly hope to know what all those local conditions are. Local lenders should, however, and that is why we hold them responsible for accurate appraisals.

Finally, we are considering establishing a tracking process that would expose appraisers consistently performing poor appraisals. Once these individuals are identified, we could instruct lenders to discontinue using them.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GORTON FROM

KENNETH J. THYGERSON

PRESIDENT AND CHIEF EXECUTIVE OFFICER

FEDERAL HOME LOAN MORTGAGE CORPORATION

1. In their testimony, the Mortgage Insurers expressed great concern over the quality of real estate appraisals they are seeing.

a. Should Freddie Mac require more information on their appraisal forms, such as whether or not the comparables have a buy down?

ANSWER

Freddie Mac's underwriting guidelines already address the need to include the impact of different financing mechanisms on property values. With respect to residential properties, Freddie Mac requires its approved sellers to use Residential Appraisal Report Form 70. Included in this form is a "Sales and Financing Concessions" section which the appraiser is required to include for the subject property and comparable properties to obtain the market value. The Freddie Mac underwriting guidelines provide clear directions as to the type of information that should be considered in this section of the appraisal:

> The "Sales and Financing Concessions" section should include appropriate adjustments for different types of financing or special marketing concessions, such as buydowns, furniture, dollar refunds, allowances over a specified number of months, or apportionment of rent payments toward down payments.
>
> If a sales transaction includes discount points, buydowns or other special sales or financing concessions, the appraisal report must demonstrate that such practices are customary in the property's area. To be customary, such practices must be used by a substantial number of sellers in a significant number of sales transactions. If the appraiser can demonstrate that the practice is customary, no adjustment in the market data analysis may be required. The appraiser must, however, fully explain the effects such financing or concessions have upon the final estimate of market value. If the practice is not customary for the area, the appraiser must treat the practice as a sales or financing concession and adjust the market value accordingly.

b. Why should Freddie Mac not have an "Approved Appraiser List" the way they have lists for approved lenders and insurers"?

ANSWER

By its charter, Freddie Mac is authorized to purchase residential mortgages from any Federal home loan bank, the Federal Savings & Loan Insurance Corporation, the Federal Deposit Insurance Corporation, the National Credit Union Association, any member of a Federal home loan bank or any other financial institution whose deposits are accounts which are insured by an agency of the United States. The corporation is also authorized to purchase and make commitments to purchase from any financial institution whose deposits are accounts insured under the laws of any state or from any mortgagee approved by the Secretary of Housing and Urban Development for participation in any mortgage insurance program under the National Housing Act. In the latter case, the institution must meet and maintain certain financial requirements established by Freddie Mac.

It is Freddie Mac's responsibility to ensure that the loans it purchases are of investment quality. As Freddie Mac purchases mortgages subject to warranties provided by the seller of the mortgages, we must ensure that the seller has the financial capability to repurchase mortgages in the event these warranties are violated.

As the appraiser does not make appraisals directly for Freddie Mac but for the primary lender, we require that the lender must select and approve the appraiser making the appraisal. Freddie Mac does require that the appraiser be experienced and active in appraisal work. The seller has a contractual relationship with us to stand behind the documentation which is submitted in connection with the loan; therefore, in the event the appraisal is found to be deficient, we require that the seller of the loan repurchase it. Our relationship is with the seller and not with the appraiser.

Freddie Mac does, however, approve and monitor private mortgage insurance companies. The mortgage insurance companies provide financial protection to Freddie Mac since they pay the first portion of a loss in the event a property is eventually owned by Freddie Mac. Therefore, for its financial protection, Freddie Mac must approve and monitor the mortgage insurance companies.

Senator GORTON. We would like to thank each of you.

The second panel, Mr. Beeksma, Mr. Dunn, Mr. Lasko, and Mr. Colton.

STATEMENT OF WARREN LASKO, EXECUTIVE VICE PRESIDENT, MORTGAGE BANKERS ASSOCIATION OF AMERICA

Mr. LASKO. Thank you, Mr. Chairman, members of the subcommittee. My name is Warren Lasko. I am the executive vice president of the Mortgage Bankers Association of America.

Senator GORTON. I will say for you and for the other members of this panel, we would appreciate your limiting your oral statements to 5 minutes. Your entire statement will be submitted for the record.

Mr. LASKO. Thank you, Mr. Chairman.

In my summary statement, some of the material has been covered, so I will be brief.

I would note in passing that until recently I was with the Government National Mortgage Association.

The Mortgage Bankers Association is an association of real estate lending institutions. Our members make about 30 percent of all home mortgages.

With respect to adjustable rate mortgages, they have clearly grown dramatically in popularity in recent years. They represent about 60 percent of all conventional home loans closed in 1984. Even this year they represent about 50 percent of all conventional financing.

There are basically two points we would want to stress, and you have heard them already, but I think in summary they will bear repeating.

ARM'S A NATURAL DEVELOPMENT

One is that adjustable rate mortgages have been a natural development, rising out of the tumultuous changes in the Nation's credit market over the last few years.

Second, they are, indeed, in the vast majority of instances, beneficial to the home buyers and to housing.

Let me just elaborate briefly on those two points.

In terms of their growing out of market forces, the first major event that brought about ARM's was a change in Federal Reserve policy back in October 1979, that gave rise to much greater volatility of interest rates. It led mortgage lenders simply to be unwilling to take the risk of getting locked into long-term, 25- or 30-year fixed rate instruments when they didn't know what the cost of their own funds would be next month, much less next year, and 25 years from now.

Following upon that, there was the deregulation of thrift institution rate ceilings. No longer did the major sources of mortgage credit have the protection of low-rate cost of money; they had to compete in the market, usually for short-term funds, again tending to drive them away from fixed rate, long-term instruments.

Third, the shape of the yield curve. Adjustable rate mortgages really didn't take off in popularity until 1983–84. When you look at the yield curve, the steepness of it, only by mid-1983, for the first time since the mid-1970's, did the yield curve turn sharply steep, meaning that short-term rates were much lower than long-term rates and ARM's were indeed attractive to homeowners.

What we are saying is there is the groundwork of market forces, and then following that, we had the institutional responses that you have heard about already from the regulatory agencies.

The Comptroller of the Currency, and the Home Loan Bank Board came out in early 1981 with authority for their supervisory institutions to make ARM's, and then Fannie Mae and Freddie Mac really did lead the way in standardizing ARM's for the secondary market.

With that kind of background, let me just hit three highlights on why the adjustable rate mortgages, given this environment and with appropriate disclosures and consumer protections, are typically and generally beneficial to home buyers.

First, they increase the supply of funds for housing. Lenders in today's volatile markets simply don't want to be locked into long-term, fixed rate loans, and without adjustable rate loans and without lenders to earn interest rates commensurate with current conditions, the supply of credit would be measurably less.

Second, home buyers invariably achieve a lower initial interest rate on an ARM than they would on a fixed rate loan. This translates into a lower cost of acquiring a given home. In fact, for many homeowners, it means the difference between qualifying or, in other words, being able to buy a home and not being able to buy one.

Finally, we think there is just no doubt that ARM's helped sustain—and you have heard this already this morning—helped sustain the housing boom through 1984, as interest rates rose dramatically.

Putting that another way, the availability of adjustable rate financing helped preserve housing's share of the overall level of economic activity and housing's due share of the total credit market.

Having said all that, we would, nonetheless, readily acknowledge that problems have occurred, namely, the use of teaser rates, with which you are familiar. We, as mortgage lenders, abhor teaser rate type practices, and it is fair to say that they have been virtually eliminated.

The Mortgage Bankers Association, as well as many others, of course, have affirmatively gone out to our members, urging them to educate and counsel borrowers, borrowers who are considering the use of adjustable financing. We, too, have prepared a consumer education brochure. We have distributed over 250,000 of these free through our membership. We are now distributing the new brochure the Federal Reserve has come out with. We feel that we are doing our part to avoid abusive practices and educate the public.

We feel that this is largely behind us, and with responsible State, national, and local organizations taking a strong lead in consumer protection, we simply don't believe that there is a need at this point in time for Federal legislation for these purposes.

STANDARDIZE DISCLOSURE REQUIREMENTS

We would note, just in conclusion, that there are two things that might enter the conversation, however. We strongly support efforts to further standardize the disclosure requirements of the various Federal agencies. Mortgage bankers at present, when making a loan, aren't always certain to what type of institution that loan will be sold. They, in effect, have to meet the disclosure requirements of three different agencies—the Federal Reserve, the Comptroller of the Currency, and the Home Loan Bank Board.

So in that connection, we encourage the Federal Reserve Board—and they are looking at this—to take the lead to develop disclosure regulations that can serve as a standard throughout the lending community.

Finally, we urge the adoption of a Veterans' Administration adjustable rate mortgage program, comparable to that authorized through FHA. We would also urge that the statutory limitation requiring rate changes of no more than 1 percent per adjustment period, which is a requirement that applies to FHA, be changed. That particular limitation is probably the overriding reason that FHA is doing virtually no adjustable rate mortgages these days.

In conclusion we, as lenders, believe that adjustable rate mortgages, when properly administered, are a sound means for a typical family to finance their home. The use of adjustable rate financing will fluctuate mainly in response to the shapes of the yield curve, but they should remain a part of the housing and finance menu.

Thank you, Mr. Chairman, very much.

[The complete prepared statement follows:]

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Mortgage Bankers Association of America

STATEMENT OF

WARREN LASKO
EXECUTIVE VICE PRESIDENT

MORTGAGE BANKERS ASSOCIATION OF AMERICA

before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER AFFAIRS

and the

SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

of the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

Hearings on

Adjustable Rate Mortgages

April 19, 1985

Mr. Chairman and Members of the Subcommittees, my name is Warren Lasko. I am Executive Vice President of the Mortgage Bankers Association of America.* MBA is the trade association of the Nation's mortgage banking and real estate finance industries. Accompanying me today are Burton C. Wood, MBA's Legislative Counsel, and William E. Cumberland, MBA's General Counsel.

We appreciate the opportunity to appear before these Subcommittees to discuss adjustable rate mortgages (ARMs). Mortgages with interest rates that are adjusted periodically have grown in popularity during the last several years. ARMs represented about 60 percent of all conventional home loans made in 1984. We estimate that initial rates on ARM loans during 1984 were typically 8.7 percent lower than if the buyer instead used a fixed rate loan. As a result, many house purchases were made possible that otherwise might not have been.

While some problems have occurred, mainly in the form of so-called "teaser rates," these are largely behind us. New disclosure procedures established by the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) provide ample consumer disclosure and protection, and have been widely adopted throughout the private sector. We also are witnessing a standardization of adjustable rate mortgage instruments that will further improve consumers' ability to comparison shop. We do not believe Federal legislation is needed to further standardize the instruments or to prescribe consumer protections.

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*The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of mortgage and real estate finance. MBA's membership comprises mortgage originators, mortgage investors, and a variety of industry-related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, financing, selling, and servicing real estate investment portfolios. Members include:

- Mortgage Banking Companies
- Mortgage Insurance Companies
- Life Insurance Companies
- Commercial Banks
- Mutual Savings Banks
- Savings and Loan Association
- Mortgage Brokers
- Title Companies
- State Housing Agencies
- Investment Bankers
- Real Estate Investment Trusts

MBA headquarters is located at 1125 15th Street, N.W., Washington, D.C. 20005; telephone: (202) 861-6500.

MBA has encouraged its members to educate, advise, and counsel borrowers considering an ARM loan. To that end, MBA has prepared an ARMs brochure, 250,000 copies of which have been distributed. Copies also have been furnished to the Banking Committee.

HISTORY

ARMs include a wide variety of mortgage loans that do not have a fixed interest rate over the entire term of the loans. ARMs are more a function of volatility than level of rates. The fixed rate loan has been the primary mortgage instrument for the past 50 years. Until 1980, the fixed rate mortgage was virtually the only product available nationwide. As mortgage interest rates have become more volatile, along with all other rates, since late 1979, ways have been sought to keep lenders from deserting the long term mortgage markets. The ARM provides a means to allow the homebuyer to qualify for a loan and purchase a house that the borrower could not otherwise obtain, while simultaneously providing lenders with a degree of protection against unpredictable increases in their costs of funds.

The ARM allows investors to reduce the risk that interest rates will increase. As interest rates increase, the investment value of a fixed rate mortgage diminishes. With an ARM, the trade-off for passing part of that risk on to the mortgagor is the lower initial interest rate on ARMs. For example, on April 11, 1985, the FNMA rate for a standard one-year

ARM loan was 10.4 percent, while a FNMA fixed rate loan was priced to yield 12.7 percent.

Also, ARMs attract increased funds into the housing market. This is because the ARM in effect converts a long term loan into a short term instrument--one on which the interest rate is readjusted periodically to a market rate, and thus back to a value close to par.

No one can predict what will happen over the next 30 years (the usual term of a mortgage loan). The size of the Federal deficit and the Federal government's demand on the credit markets threaten us with further inflation and higher interest rates. Long-term investors demand a greater return for the long-term risk they take in this uncertain economic climate. ARMs reduce that risk to a degree and that is reflected in the interest rates. Although the risk that rates may increase is shared with the borrower, the Subcommittees should not overlook the fact that the interest rate of an ARM can go down as well as up. Many borrowers who opted for ARMs in the peak periods in 1980 and 1981 enjoyed downward adjustments in their rates in late 1982, early 1983, and early 1984. MBA has no doubt that if Federal deficits were significantly reduced, this would result in significantly lower interest rates.

The ARM became available nationwide in 1980. Initially, it was not a popular loan instrument with the borrower because a greater degree of the interest rate risk was placed on the borrower. Few of the early ARMs carried annual or lifetime payment or interest rate caps. In addition, the initial rates were not significantly less than the prevailing 30-year fixed rate.

In January 1983, ARMs accounted for approximately 35 percent of conventional new home loans originated. During 1983, several new ARM products came on the market that offered annual interest rate or payment caps, as well as a lifetime interest rate cap. The protection against unlimited interest rate risk, a restriction of the annual increase, and a lower initial rate made the ARM much more popular. Public understanding of the terms led to greater acceptance. In late 1983, ARMs captured more than one half of the conventional loan market. This ratio peaked at over 65 percent of the market in mid 1984, before settling back to approximately 50 percent in early 1985. Exhibit A demonstrates the growth of ARMs since January 1983.

An ARM is primarily for the homebuyer whose income is expected to increase over the initial few years. Because it is initial interest rate that is used to determine whether the homebuyer can afford the monthly payments of principal, interest, taxes and insurance, it allows the homebuyer to qualify for a larger mortgage than for a fixed rate loan carrying a higher interest rate. For example, we estimate that the average prevailing rate for fixed rate conventional mortgages in 1984 was 13.2 percent, based on Federal Home Loan Bank Board data. Using the most recent census statistical distribution of household income,[1] approximately 30.7 million households have sufficient income to qualify for a $55,000 mortgage using typical underwriting criteria, according to MBA's Economics Department. The average ARM in 1984 had a rate of 12.04 percent. That interest rate would allow an additional 3.4 million households to qualify for the $55,000 loan. Should interest rates rise, however, the homeowner would need a higher income to afford the higher payments.

A second type of homebuyer who may be well served by an ARM is one who expects to be in the home only a few years. The short-term owner can take advantage of the low initial rate and the limitations on annual increases, and be out of the house before the interest often a short-term owner seeking to move up in a few years. In cases where the initial rate is low and there is no prepayment penalty, the ARM may serve that consumer well.

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[1] "Money Income of Households, Families, and Persons in the United States," 1982. U.S. Department of Commerce, Bureau of Census, February 1984.

During periods of extraordinarily high interest rates, the ARM will be the only way large numbers of buyers can afford a home at all. Thus, homebuyers are not shut out of the market when interest rates move upward. The ARM interest rate also adjusts downward when interest rates fall. Exhibit B compares the interest rates of fixed rate mortgages to ARMs. Exhibits C and D compare the after tax ratio of income to mortgage payment between an ARM and a fixed rate mortgage. In our example, which assumes a two percentage point increase in the ARM interest rate per year, in early years the ARM payment represents a lower percentage of the buyer's income. In later years it takes up a slightly greater amount.

DELINQUENCY EXPERIENCE

To date, we do not have any hard data on delinquency or foreclosure rates on ARMs. Because the widespread acceptance of ARMs has taken place only recently, the industry has not been able to gather the relevant data necessary to make a valid assessment. The adjustment periods on one- and three-year ARMs are occurring now. We do not have sufficient data to make a proper analysis. MBA's National Delinquency Survey data collection process is being reexamined now to seek a method of ascertaining information regarding ARMs default and foreclosure experience.

We do not yet know whether an upward adjustment in the ARM is a frequent reason for borrowers' delinquency or default. If a homebuyer suffers a financial crisis or is laid off and cannot make the mortgage payments, it does not matter whether the loan is a fixed rate or an ARM.

Graduated Payment Mortgages (GPM)

GPMs are similar to ARMs in that the payments increase during the early years of the loan. Our experience with FHA-insured GPM is quite favorable. For example, according to MBA's National Delinquency Survey, during the fourth quarter of 1984, the delinquency rate on GPMs was 7.76 percent, less than the 8.18 percent delinquency rate for all FHA-insured loans. The GPM program has demonstrated that thousands of homebuyers are able to adjust to gradually rising payments to gain the other advantageous features of the new mortgage instruments.

The matter of foreclosure from the investor's and the loan servicer's point of view should also be considered. Although loss on an investment does not compare with the loss of one's home, foreclosure is the last thing a lender wants. Prior to foreclosure, serious efforts are made to ascertain the reason the borrower has failed to make payments and whether the problem can be worked out.

Investors buy mortgages in order to obtain a long term fixed return. Loan servicers only profit when borrowers make timely payments over the life of the loan. A foreclosure is an expensive, losing proposition for all parties.

DISCLOSURE

Consumer education is an extremely important element in the process of making a loan. Prospective homebuyers can no longer compare only fixed rate loans between various lenders, but also must take into account how those loans compare with ARMs. There are many more products on the market and many more terms to compare. In order to compare the features of each loan the buyer must understand the definitions and how they interrelate with each other and with changes in the economy. In this regard, MBA strongly believes that full disclosure to mortgage borrowers is not the single answer to these complex considerations. Borrowers must also be helped to understand the possible ramifications of the loans they are trying to evaluate.

The education of the homebuyer is the duty of the realtor, the lender, and the homebuyer. MBA has urged its members to go beyond the statutory disclosure requirements in order to educate borrowers.

Mortgage shoppers often must select among programs that offer seemingly similar terms. The following demonstrates two different examples of one-year ARMs each tied to the yield on one-year Treasury securities, but which could have significantly different outcomes.

The terms of these options are very close. But depending on the movement of the yield on one-year Treasury securities, over time, one option will work out significantly different from the other.

SAMPLE ARM COMPARISON

	Option 1	Option 2
Initial rate	11.5%	12.5%
Adjustment period	1 year	1 year
Margin	2.5 percentage points	2.0 percentage points
Annual cap	2.0 percentage points	2.5 percentage points
Lifetime cap	6.0 percentage points	4.5 percentage points
Index	One-year U.S. Treasury security yield	One-year U.S. Treasury security yield

Option 1 is cheaper in the first year and will allow the homebuyer to qualify for a larger loan. Option 1 also offers greater protection against annual payment increases. Option 2, however, provides greater protection against lifetime interest rate increases. It also would be less expensive after the first adjustment period, because its margin is lower, unless the cap in Option 1 is exceeded by at least 0.5 percent. The consumer must make a choice based on his or her present financial condition, anticipated growth in income, and the amount of interest rate risk he or she is willing to bear.

Many of the examples cited that show the improper use of ARMs involve deep discount "teaser rates," no payment increase protection or caps, and/or negative amortization. This sort of loan is a candidate for default for several reasons. The low initial "teaser rate" was used to qualify the borrower. The adjustment of the loan to market could be a heavy blow. The adjustment is not limited and, therefore, the loan payment cannot phase up to the market rate. In cases with low down payments and negative amortization, the buyer may owe more than the original loan amount or in extreme cases, more than the house is worth. Because the investment in the house is small and the debt is growing, there could be an incentive to walk away from the house if interest rates rise substantially. We believe that a substantial number of foreclosures involve loans with a low downpayment, deep discount, and negative amortization.

During the 1970s, investors and lenders could make loans with the fairly safe assumption that the real estate would increase sufficiently in value to satisfy the loan in the event of a default. This is no longer the case, because the escalation in house prices has slowed along with the general pace of inflation.

The goal of the lender and the investor is to keep the homebuyer in the house making regular payments on the mortgage. Everyone loses in a foreclosure. Therefore, the underwriting of the loan, to determine whether the homebuyer will be able to afford the payments today and next year, is the key to the successful use of ARMs.

ARM REGULATORY DISCLOSURE PROBLEMS

In addition to the confusion a borrower may encounter when shopping for an ARM, the Federal agencies that regulate credit disclosure have generated confusion of their own. Until April of this year, the Federal Reserve Board's (FRB) Truth-in-Lending provisions governing disclosures on variable rate loans were open to interpretation. Comment in Section 226.18(f) in the Official Staff Commentary and Section 226.17 of Regulation Z itself seemed to give contradictory instructions concerning variable rate disclosures. The Official Staff Commentary states that disclosures should be based on the terms in effect at the time of consummation of the loan. Section 226.17 of Regulation Z mandates that, with regard to disclosures with initial rates that are lower than the contracted-for rates will be in later years, the disclosure should reflect the terms of the legal obligation between the parties and take into account both the lower and higher rates.

To make matters more confusing, the Commentary states that in a variable rate transaction with a buydown, disclosures should not be based solely on the initial rate, but that the disclosed annual percentage rate should be a blended rate based on the lower rate for the buydown period and the rate that is the basis of the variable rate features for the remainder of the term. This gave rise to questions of whether ARMs were subject to these requirements for buydowns.

A great deal of confusion resulted from this inconsistency. In July 1983, the Federal Home Loan Bank of New York issued an informal interpretation requesting lenders to use a "blended" rate for purposes of disclosure. The blended rate was based on the initial rate for the length of time it was effective and the fully indexed accrual rate, as calculated at consummation, for the rest of the term of the loan.

The Federal Trade Commission, which enforces Regulation Z for independent mortgage lenders, followed the Federal Home Loan Bank of New York's lead in interpreting the regulation and initiated proceedings against several lenders who continued to disclose based on the initial rate only. The FRB staff itself gave conflicting information in response to inquiries.

A formal request for clarification from the FRB prompted the change in Regulation Z, issued April 5, 1984 (49 FR 13485), that requires a composite APR based on "the initial rate for as long as it is applied and, for the remainder of the term, the rate that would have been applied using the index or formula at the time of consummation."

The Federal Home Loan Bank Board (FHLBB) required Federal savings and loan associations to convert to this disclosure method by March 1, 1984. Under the regulation, effective October 1, 1984, lenders must comply with the new procedure. This standardized and more accurate disclosure method will increase the uniformity of ARM instrument disclosures and reduce confusion and inconsistency in the marketplace.

A problem of growing concern to those interested in maintaining a secondary market for mortgage instruments is the differences in the ARM disclosure requirements contained in the Office of the Comptroller of the Currency's (OCC) regulations and those found in the FHLBB's regulations. The differing requirements are significant because under OCC regulations, banks may purchase, as well as originate, only loans which have followed OCC requirements. Under FHLBB regulations, if thrifts have a commitment to purchase loans that have not yet been originated, then those loans must comply with FHLBB disclosure procedures. However, if a thrift is purchasing loans that have already been originated, then those loans need only adhere to the regulations imposed on the originating lender. As a result, mortgage bankers who are originating loans for sale in the secondary market must meet both the FHLBB and OCC disclosure requirements to be assured that the loans are saleable to all potential investors.

The Alternative Mortgage Transactions Parity Act of 1982, Title VIII of the Garn-St Germain Depository Institutions Act of 1982, permitted most non-federally regulated housing creditors to make ARM loans or other alternative mortgage loans, without regard to state law, which otherwise would prohibit such transactions, as long as the ARMs fully comply with the regulatory requirements imposed upon them either by the FHLBB, the OCC, or the National Credit Union Administration (NCUA). Under the Act, national and state banks and their subsidiaries, including mortgage banking companies, (but not holding company subsidiaries), must follow OCC regulations on alternative mortgage transactions.

Credit unions, on the other hand, are to look to the NCUA, while the remaining housing creditors, which includes most mortgage bankers, are under FHLBB jurisdiction.

This legislation then contributed to the confusion created by different disclosure requirements for various originators of ARMs and the differences in the regulatory schemes have significantly inhibited the transferability of the mortgage instruments. For example, FHLBB regulations require a mortgagee to provide an "example of the interaction of all variable features of the loan over any period of time." As difficult as this is, given the possible combination of features in today's ARM loans, such an "example" still may not comply with the comparable OCC ARM disclosure requirement. The OCC requires the inclusion of a schedule of the dollar amounts of the installment payment and the outstanding loan balance at each payment adjustment date, assuming an initial balance of $10,000 and an interest rate index increase of one point per six months for the first five years of the loan term. If the example provided under FHLBB regulations does not meet OCC requirements, then a bank cannot purchase the loan.

The timing requirements also are different under OCC and FHLBB regulations. The Comptroller requires written disclosures "on the earlier of the date on which the bank first provides written information concerning adjustable rate mortgage loans available from the bank or provides a loan application to the prospective adjustable rate mortgage borrower." The FHLBB, on the other hand, requires disclosure "(n)ot later than three business days following receipt of a written application . . . ." Therefore a mortgage banking company would have to follow the OCC requirement, though substantially more stringent than that provided for in the FHLBB's regulation, in order to have the flexibility to sell the loan to a commercial bank.

The Federal banking agencies have been working since last fall on developing uniform disclosure requirements. After the Federal Financial Institution Examination Council (FFIEC) failed to propose a set of requirements acceptable to all the agencies, the Federal Reserve Board was asked by the FFIEC to develop the requirements. They have not yet released a proposal.

MBA supports the efforts to standardize the disclosure requirements and has encouraged the Federal Reserve Board to develop regulations acceptable to all the agencies.

SOLUTIONS

The market is moving rapidly towards correcting the problems that have arisen in the early life of ARMs. There is a standardization process going on. The secondary mortgage market participants have established, and recently tightened, their underwriting guidelines for ARMs that they will purchase or insure. In addition, the investors and insurers are restricting the size of the initial discount to reduce the possibility of severe payment shock as well as the amount the mortgage payment or interest rate may adjust during any period and/or over its life. They are also restricting the rate at which a loan may negatively amortize, and the total allowable negative amortization. The Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) have both announced that they will no longer purchase heavily discounted loans with "teaser rates."

Standardization will make the ARM more saleable in the secondary market. Standardization of the product will also help consumers because they will be better able to compare the loan products when some of the variables are limited or more easily compared.

In 1984, FHA published its ARM regulations. This should have led to further standardization because consumers would have had a government program to use as a basis for comparison. However, the FHA ARM has failed to attract enough interest in the capital markets to develop a meaningful program.

The FHA ARM is too conservative an instrument. By statute, upward interest rate movements are limited to one percent per year and five percent over the life of the instrument. FHA regulations specify that the one-year Treasury bill index is to be used, and that negative amortization is prohibited.

MBA is now working with HUD to amend and expand the FHA ARM program so that it can be attractive to Wall Street through the GNMA mortgage-backed security program. We are hopeful about the final result. Meanwhile, the FHA experience demonstrates concretely the difficulty in setting limits at all, and the danger of setting them so low that consumers are deprived of potential benefits.

CONCLUSION

The ARM is here to stay. The shopper in the home mortgage market will require a greater understanding of the products available. The 30-year, fixed rate loan will continue to be the preferred means of financing only if it is affordable. As interest rates passed the 13 percent mark in 1983, the home buying public looked for other ways to finance the purchase of a home.

The ARM when used properly is a valuable product. The early ARMs did not provide the consumer protections that have been recently been developed in response to borrower and investor demands. A foreclosure problem may develop among those early ARM borrowers. That will depend on the course of interest rates over the next few years. Consumer education, standardization of terms, and reasonable borrower protections such as negotiated limitations on interest and payment changes will make the ARM a more viable alternative to fixed rate loans.

We appreciate the opportunity to appear before the Subcommittees and will be happy to furnish any additional information as may be needed.

APPENDIX

DEFINITIONS

An ARM is a home mortgage loan that has an interest rate that is not permanently fixed at the time it is made. The rate can be adjusted throughout the life of the mortgage. There may be limits as to the adjustments.

The following terms have come into standard use in describing ARM loans.

Assumability. This is a provision of the loan that may allow, disallow, or set forth the specific conditions under which another borrower may take the original borrower's place. Many ARMs are assumable under certain conditions.

Buydown. Money advanced by an individual (builder, seller, etc.) to reduce the monthly payments for a home mortgage either during the entire term or for an initial period of years.

Convertible to Fixed Rate. This is an option in the loan that allows the borrower to convert the adjustable rate feature to a fixed rate loan at a specified adjustment date. Both the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) purchase loans with this feature.

Index. This is a published index upon which adjustments to the loan's interest rate are based. Changes in this index will cause the loan's interest rate to change. Common indices are U.S. Treasury issues adjusted to a constant maturity for the same time period as the ARM's adjustment period.

Initial or First-Year Interest Rate. This is the interest rate during the first period of the loan term, prior to the first adjustment. It is usually lower than the prevailing rate for a fixed rate loan. The lower rate allows more homebuyers to qualify for the home they have chosen than would otherwise be the case if only fixed rate loans were available.

Interest Rate Caps. These are limitations on the amount by which the interest rate on the loan may increase or decrease during an adjustment period and/or over the life of the loan. Most ARMs have both periodic caps as well as a lifetime maximum rate that cannot be exceeded.

Margin. This is the number of percentage points added to the index to determine change in the ARM interest rate. For example, a loan that has the one-year Treasury bill yield as an index may have a margin of two percentage points. At the adjustment date, the new interest rate, therefore, would be calculated as the one-year Treasury bill yield plus two percentage points, subject to any applicable rate cap.

Negative Amortization. This occurs if a payment cap restricts the monthly payment to a level less than the amount of monthly interest due on the loan. The unpaid interest is added to the remaining principal amount.

Payment Caps. These are limitations on the amount the monthly payment on the loan may increase either during any given adjustment period and/or over the life of the loan. Payment caps limit the amount the monthly payment may change in terms of dollars rather than interest rate percentage points. A payment cap may result in negative amortization. Not all ARMs have payment caps.

Payment Shock. This is the term commonly used to describe large increases in monthly payments that may occur when interest rates increase rapidly during an adjustment period or over the life of the loan.

Points, Origination Fees, Up-front Interest. These are fees charged when the loan is originated. They increase the effective interest rate. They must be included in the calculation of the Annual Percentage Rate (APR). One point is equal to one percent of the mortgage amount.

Prepayment Charge. This is a fee assessed against the borrower if the loan is paid off prior to an agreed upon date. Its purpose is to discourage the early partial or full payoff of the loan. Many ARMs do not have a prepayment charge.

The terms of a typical ARM are as follows:

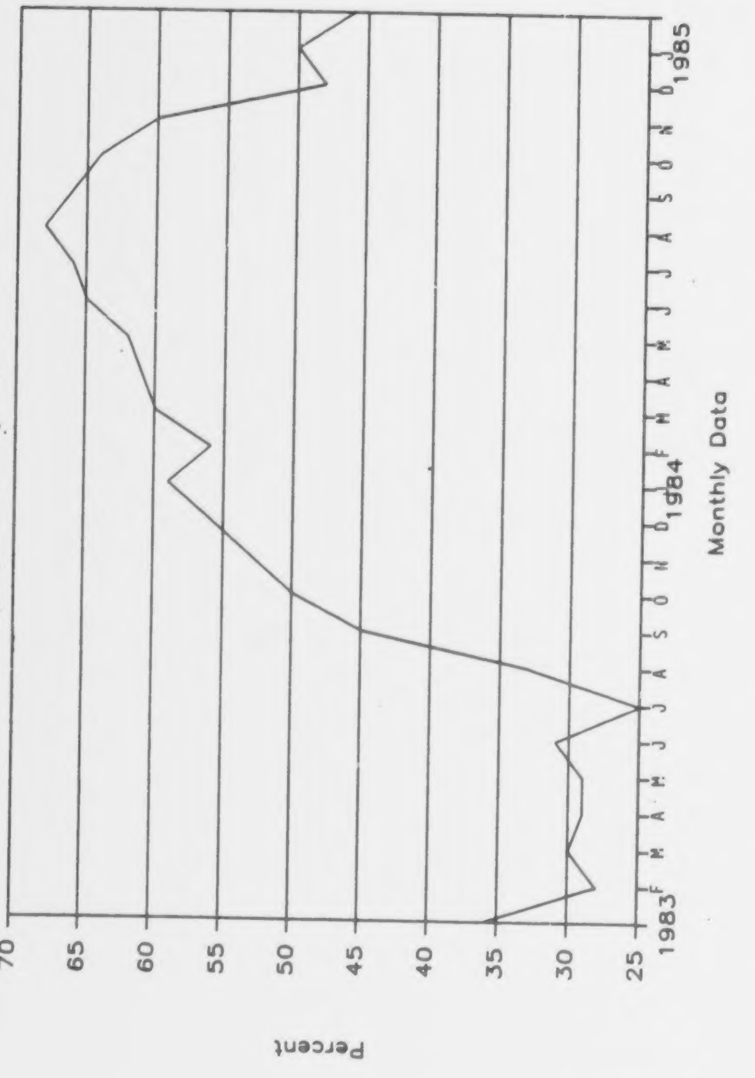
Index	One-year Treasury security
Margin	2.5 percentage points
Initial rate	11 percent
Payment cap	none
Interest rate cap	2 percentage points per adjustment period 5 percentage points over loan life
Assumable	yes
Negative amortization	no
Convertible to fixed rate	no
Loan-to-value ratio	75 to 95 percent
Investor	thrift institutions, life insurance companies, federally related agencies.

Chart to Accompany Statement of Warren Lasko
April 19, 1985

EXHIBIT A

ADJUSTABLE RATE MORTGAGES CLOSED AS
A PERCENT OF CONVENTIONAL MORTGAGES CLOSED

(January 1983 - February 1985)



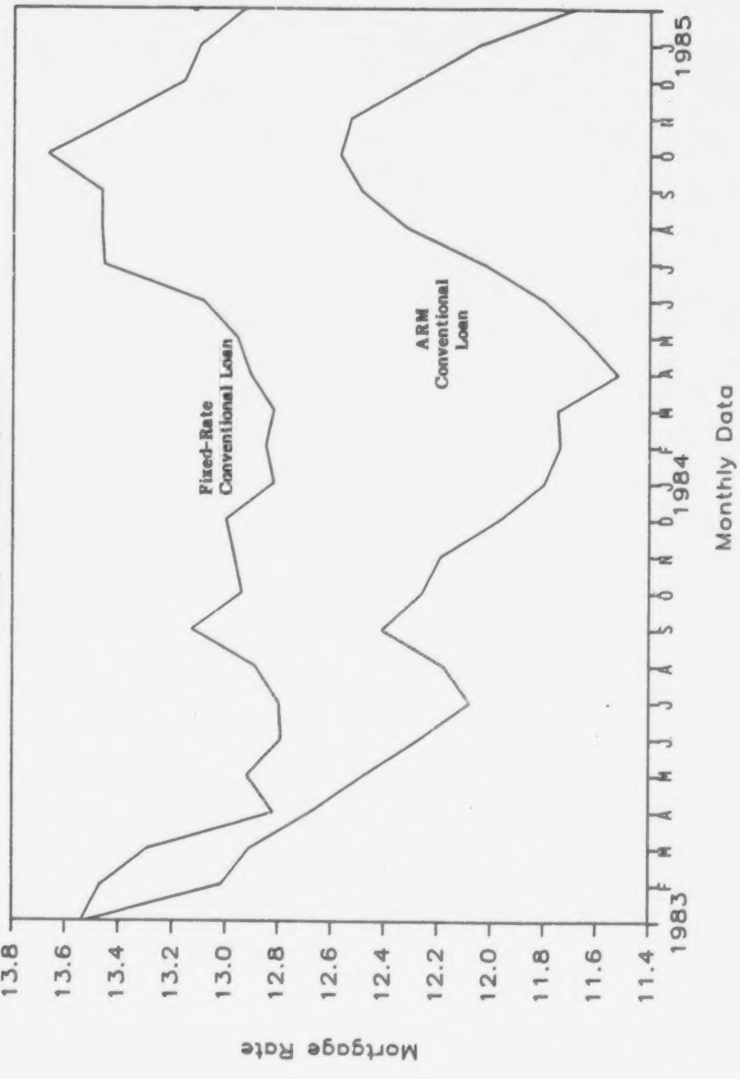
Source: Federal Home Loan Bank Board
Prepared by MBA Economics Department, April 1985.

Chart to Accompany Statement of Warren Lasko
April 19, 1985

EXHIBIT B

EFFECTIVE MORTGAGE RATES ON CONVENTIONAL LOANS CLOSED

(January 1983 - February 1985)



Source: Federal Home Loan Bank Board
Prepared by MBA Economics Department, April 1985.

Table to Accompany Statement of Warren Lasko
April 19, 1985

EXHIBIT C

RELATIONSHIP OF MORTGAGE PAYMENTS TO HOUSEHOLD INCOME FOR AN ADJUSTABLE RATE MORTGAGE ASSUMING MAXIMUM PAYMENT INCREASE[1]

Loan Amount:	$50,000
Loan Period:	30 years

	Year 1	Year 2	Year 3	Year 4
Interest Rate	12%	14%	16%	17% (max.)
Total Monthly Payment (PITI)[2]	$ 664	$ 742	$ 820	$ 860
Monthly Deductible Payment[3]	611	693	774	814
Tax Savings[4] (Deductible times Tax Rate)	134	152	170	179
After Tax Monthly Payment (Total Monthly Payment minus tax savings)	530	590	650	681
Estimated Monthly Income	2,371[5]	2,554[6]	2,751[6]	2,963[6]
Estimated Annual Income	28,452[5]	30,648[6]	33,012[6]	35,556[6]
Ratio of After Tax Payment to Monthly Income	22.4%	23.1%[6]	23.6%[6]	23.0%[6]

1. Example of an adjustable rate mortgage adjusted annually with an interest rate cap of 2 percentage points per year and 5 percentage points over the life of the loan with the maximum interest rate during the first four years.

2. Includes Principal, Interest, Property Tax, and Insurance.

3. Deductible includes Monthly Interest and Property Tax Payments. Property Tax is 75 percent of $150. (Monthly Total for Insurance and Property Tax.)

4. Based on a 22 percent Marginal Tax Bracket (Federal Income Tax only).

5. Based on an underwriting standard of a 28 percent ratio of PITI to gross income.

6. Based on a 7.71 percent annual increase in household income. Derived from Bureau of Census data, Current Population Report Series P-60, No. 142.

Prepared by MBA Economics Department, April 1985.

Table to Accompany Statement of Warren Lasko
April 19, 1985

EXHIBIT D

RELATIONSHIP OF MORTGAGE PAYMENTS TO HOUSEHOLD INCOME FOR A FIXED-RATE MORTGAGE COMPARABLE TO EXAMPLE IN EXHIBIT C

Loan Amount:	$50,000
Loan Period:	30 years

	Year 1	Year 2	Year 3	Year 4
Interest Rate	14%	14%	14%	14% (max.)
Total Monthly Payment (PITI)[1]	$ 742	$ 742	$ 742	$ 742
Monthly Deductible Payment[2]	694	693	691	689
Tax Savings[3] (Deductible times Tax Rate)	153	152	152	152
After Tax Monthly Payment (Total Monthly Payment minus tax savings)	589	590	590	590
Estimated Monthly Income	2,650[4]	2,854[5]	3,074[5]	3,311[5]
Estimated Annual Income	31,800	34,248[5]	36,888[5]	39,732[5]
Ratio of After Tax Payment to Monthly Income	22.2%	20.7%[5]	19.2%[5]	17.8%[5]

1. Includes Principal, Interest, Property Tax, and Insurance.
2. Deductible includes Monthly Interest and Property Tax Payments. Property Tax is 75 percent of $150. (Monthly Total for Insurance and Property Tax.)
3. Based on a 22 percent Marginal Tax Bracket (Federal Income Tax only).
4. Based on underwriting standard of a 28 percent ratio of PITI to gross income.
5. Based on a 7.71 percent annual increase in household income. Derived from Bureau of Census data, Current Population Report Series P-60, No. 142.

Prepared by MBA Economics Department, April 1985.

What You Should Know About ARMs

A Consumer Guide to
Adjustable Rate
Mortgages

Prepared by the
Mortgage Bankers
Association of
America

August 1984

Lenders and borrowers have more in common today than ever before.

We have been brought together by the need to cope with the problems that high interest rates have caused for both homebuyers and lenders.

You want to buy a house, and you want a mortgage with monthly payments that are manageable for you. Your lender wants to make that loan, and needs the payments to be affordable for you.

Changes in the real estate finance environment have led to changes in the way mortgage loans are put together. Specifically, they have led to the development of adjustable rate mortgages (ARMs), which are the subject of this booklet.

There is nothing sinister or mysterious about ARMs. They are, very simply, a means by which you and your mortgage banker, or other lender, can custom-fit a mortgage to your particular needs.

An ARM can, under the right circumstances, be a valuable tool in helping you to achieve homeownership. But you should understand it and how it fits into your financial capacity and expectations. You expect your lender to ask a number of questions when you apply for a loan. You should not hesitate to ask your lender as many questions as necessary, until you are comfortable with your understanding of this new mortgage instrument.

An adjustable rate mortgage is one in which the interest rate changes periodically. This affects your monthly payment. It can go either up or down, depending on what is happening in the Nation's economy and to interest rates generally.

The question is often asked: "Are ARMs good or bad for borrowers?"

It is a question that should not be answered quickly. ARMs may be good for some borrowers, and not so good for others. It is a matter of your own financial situation.

ARMs can be a good choice for financing a home under certain conditions, such as:

- **Rising income expectations.**
  If you expect your income to increase each year, and you do not expect to accumulate extraordinary debts, then you are a good candidate for an ARM.
- **High interest rates.**
  When interest rates rise, they threaten to squeeze potential homebuyers out of the housing market, because fewer people can qualify (meet the monthly payments) for a loan at the higher rates. ARMs have beginning interest rates typically as much as one to three percentage points below those of fixed-rate mortgages. Many lenders will make loans to homebuyers if they can meet the payments on loans with the lower initial interest rates available on ARMs, which the same borrowers could not qualify for at the higher monthly payments associated with a fixed rate mortgage.
- **Short-term homeownership.**
  If you expect to move within a relatively short time because of a temporary job assignment or a transfer, an ARM can make good sense. You gain the advantages of homeownership with a lower interest rate and lower monthly payments. Then, when you move, you can pay off the ARM, sometimes without having to pay a fee.

As with any financial transaction, the terms and conditions of an ARM must be clearly understood. ARMs are complicated, unlike the simple, long-term, fixed-rate mortgage, and there is a wide variety of ARMs available in the marketplace today. Lenders are required by law to provide full disclosure of the terms and conditions of mortgage loans. But, because of the complexity of ARMs, mortgage bankers and other lenders are trying to go "beyond disclosure," to make certain that you completely understand the many features of ARMs and that you get the loan that suits you best.

Although complex, ARMs are not impossible to understand, and the **Mortgage Bankers Association of America** hopes that this booklet will help you in deciding whether the particular ARM you may be considering is right for you.

Mark J Riedy

Dr. Mark J. Riedy
Executive Vice President
Mortgage Bankers Association of America

August 1984

There are as many different types of adjustable rate mortgages (ARMs) as there are styles of houses—or so it will seem when you are faced with all the choices offered by different lenders.

Following are some brief definitions of the various features of ARMs that will help you understand how to judge whether any one ARM is right for you. Twelve features are described, and *it is important for you to understand each feature and to ask your lender to explain fully each and every feature of your ARM, to the point that you are comfortable with your knowledge.*

For a complete understanding of each feature, read the definitions first, then read the fuller explanations that appear later in this booklet. The booklet has been designed in such a way that you can easily go from the brief definitions to the more complete explanations. Simply match the number of the definition with the number preceding the more complete explanation.

We also have provided some examples of the various types of ARMs. In these examples, we use the same set of assumptions about loan amount, loan term, interest rate, etc. You should remember that any example has to be based on certain assumptions that may not apply in your specific case. But we believe the examples help in demonstrating how an ARM works.

Lastly, we give some advice about each feature of an ARM. We hope it helps, but the best advice you can get will come from your mortgage banker or other lender, or professional, who should be more familiar with your personal financial situation than we are.

All ARMs Have These Four Basic Features:

1 Initial Interest Rate

This is the beginning interest rate on your ARM. It will stay the same until it is adjusted either up or down on the adjustment date specified in your mortgage. This initial rate usually is lower than the interest rate being charged for a long-term, fixed-rate mortgage.

2 Adjustment Interval

This is a period of time between changes in either the interest rate and/or the monthly payment. The interest rate on most ARMs may change after one, three, or five years, although other adjustment intervals may be negotiated with lenders.

3 Index

The index is a published measure of interest rates on certain types of borrowings or investments. There are several types of indexes, and, when coupled with the margin, they are used by lenders to determine the mortgage loan's new interest rate at the time of adjustment. Increases or decreases in the ARM index may cause comparable increases or decreases in the interest rate of your ARM.

4 Margin

This is an additional amount the lender adds to the index to establish the interest rate on your loan.

There are several optional features that you can have added to your ARM, if the lender offers them.

5 Interest Rate Caps

There are two types of interest rate caps. The first is a limit on how much the interest rate on an adjustable rate mortgage can increase or decrease at the time of each adjustment, usually annually. The second type is a limit on how much the interest rate can increase or decrease over the life of the loan.

6 Monthly Payment Cap

The monthly payment cap is a limit on how much the monthly payment can increase or decrease at the time of each adjustment, for a specific number of years. If interest rates rise significantly after you get your ARM, a monthly payment cap may result in negative amortization. At the time of an upward adjustment, you may elect to increase your payment voluntarily to avoid negative amortization.

7 Graduated Payments

This optional feature permits monthly mortgage payments to start lower and gradually increase over a specific period of time, at the end of which time the mortgage becomes a typical ARM, with the monthly payments adjusted periodically to reflect the index plus margin. An ARM with graduated payments will also result in negative amortization during the time of graduated payments.

8 Negative Amortization

Amortization means that the monthly payments are large enough to pay the interest and reduce the principal on your mortgage. Negative amortization occurs when the monthly payment is not enough to pay all the interest due on the loan. The unpaid interest is added to the unpaid balance of the loan. Instead of reducing the amount you owe, negative amortization means you owe more than you initially borrowed. Negative amortization may occur when a monthly payment cap or a graduated payment schedule is in effect.

9 "Introductory" Rate

On an ARM, this is a beginning interest rate that is slightly lower than what the index plus margin would indicate as the "going market rate." It is offered for competitive reasons. A "teaser" rate is an introductory rate that is considerably below market rates. A "teaser" rate may result in a large increase in your monthly payments at the time of the first adjustment.

10 Assumability

This permits you to transfer your mortgage on the terms existing at the time to anyone who wants to buy your house, as long as that person meets the credit standards of the lender who made your loan. Not every ARM has an assumability feature. In fact, many ARMs will have a "due-on-sale" requirement, which means you will have to pay off the original loan at the time you sell your house.

11 Convertibility

This permits you to change, or "convert," your ARM to a fixed-rate mortgage at some predetermined time in the future, usually at certain designated times during the initial years of the mortgage. If you want to convert from an ARM to a fixed-rate loan, the lender may charge you a fee that is a percentage of the remaining balance of your loan.

12 Prepayment Privilege

This permits you to pay off your ARM at any time prior to the final maturity of the loan. Some lenders may require you to pay a fee in order to prepay the loan.

1

The Initial Interest Rate

As mortgage interest rates have risen along with all other interest rates, the home financing industry has searched for ways to help homebuyers like you purchase a home. The chart on the next page shows how interest rates on FHA and VA mortgage loans have changed over the past thirty years. Notice how relatively steady the rates were until September of 1979. Since then, because of inflation, deregulation by the Federal government, and other economic factors, the rate has jumped up and down, sometimes dramatically. This is called "volatility," and it makes any lender reluctant to offer a fixed or unchanging rate of interest on a loan for a long period of time.

By permitting adjustments to the interest rate periodically, ARMs allow borrowers and lenders to share the risk that interest rates may continue to fluctuate. The ability to adjust the interest rate to match other rates provides lenders with protection against increases in the rates they must pay for their money, and it allows them to offer borrowers a beginning (initial) interest rate on an ARM that is lower than the rate on a fixed-rate mortgage.

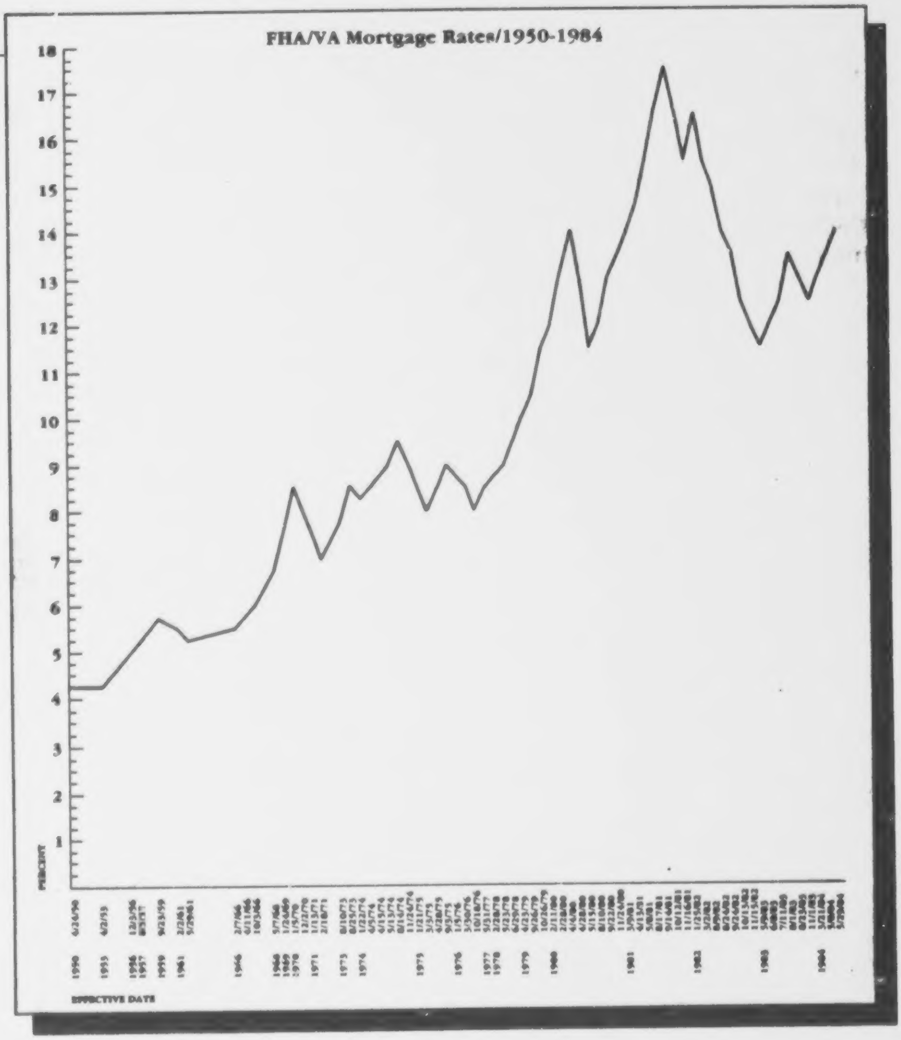
The initial interest rate on most ARMs is typically one to three percentage points below that of a fixed-rate mortgage, and it stays in effect until the time when it is scheduled to be changed.

The lower beginning ARM rate provides a way to "qualify" you (make sure you can meet future monthly payments) for a loan you might not be able to afford at the higher rates on fixed-rate loans. Although the risk exists that rates may increase, and your monthly payment may increase at the time of adjustment, it should not be forgotten that the rate on an ARM can go down as well as up. In fact, many borrowers who chose an ARM during the period of historically high interest rates in 1980 enjoyed downward adjustments in their rates in late 1982 and early 1983.

Even though the rate on an ARM adjusts periodically, the loan itself typically is for the normal 25 or 30 years. As in the case of fixed-rate mortgages, you may be charged "points" on an ARM. A point is one percent of the loan amount. The lender charges points on a one-time basis at the time you get the loan, to match the rate of return on the mortgage loan with the rate of return that the lender could get on other types of investments.

Advice on the Initial Interest Rate

The initial interest must be evaluated together with other factors. If you are seeking a low initial interest rate and are comparing one lender's rate with another, make sure you are comparing ARMs with similar features. The presence or absence of certain features may affect the rate, and, in some cases, the amount of margin the lender requires. Be careful about accepting a rate that is much lower than what most lenders are offering on ARMs. Be sure to read the explanation of "Introductory" rates on page 21.



Effective November 30, 1983, the FHA maximum interest rate no longer is set by the Secretary of Housing and Urban Development. The VA maximum rate continues to be set by the Administrator of the VA.

2

The Adjustment Interval

The adjustment interval is the amount of time that must pass between adjustments to the interest rate and/or the monthly payment. Depending on the terms of any particular ARM, the adjustment interval will usually be one, three, or five years. The adjustment interval usually matches the type of index being used. For example, an ARM that adjusts annually will most often be linked to an index based on the yield of one-year Treasury securities. The interest rate and the monthly payment established when the loan was made cannot change until the end of each adjustment period. (The length of time between changes in the interest rate may be subject to negotiation with the lender.)

Advice on the Adjustment Interval

If you believe that interest rates will go up in the future, you will probably want to bargain for the longest possible adjustment interval. But, if lenders agree with your belief that interest rates will rise, they may well expect you to pay a higher initial interest rate for a five-year, as opposed to a one-year, adjustment interval.

The adjustment interval and possible rate increases you finally accept should match closely with the time periods and amounts of your expected income increases, and with other personal factors that would influence your ability to make your mortgage payments.

3

The Index

An index is a measurement of the amount of interest that is being paid on certain types of borrowings or investments. It is used, in conjunction with the margin, to establish the new interest rate that will be charged on your ARM at the time of each adjustment.

There are many types of indexes. They are compiled by agencies of the Federal government and are usually published in the business or real estate sections of daily newspapers.

Some common indexes are:

- One-, three-, and five-year U.S. Treasury security yields
- The monthly average interest rate on loans closed by savings and loan institutions
- The monthly average cost-of-funds incurred by savings and loan institutions

The chart on the following page shows the actual movement of these indexes over many years.

These indexes are popular because they are readily available to anyone, they reflect the underlying trends of interest rates throughout the economy, and they are beyond the control of any individual lender.

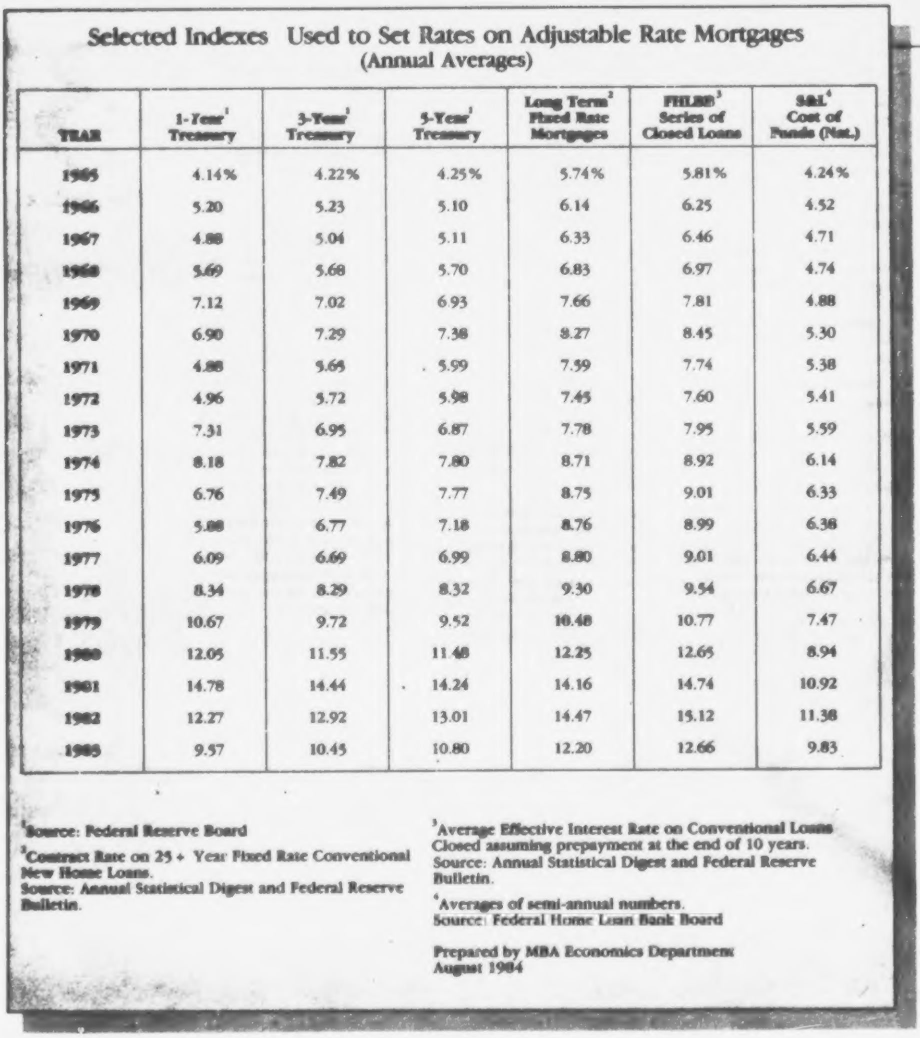
Most lenders use one-, three-, or five-year U.S. Treasury security yields as their indexes.

Some indexes tend to change more than others. It is generally true that indexes with shorter maturities are more volatile—upward and downward—than longer-term indexes.

Because indexes reflect the general movement of interest rates in the national economy, lenders rely upon them to make certain their rates are competitive with other lenders and yet not so low that they are likely to lose money.

Advice on Choosing an Index

Choosing the right index is an important decision, because every index performs differently. An index that has a relatively stable performance over time and does not tend to fluctuate significantly may be the most desirable. However, it is not necessarily true that the most stable index will give you the lowest rate. You should consider what kind of a trade-off you want to make when deciding on an index. The choice may be between an index with relative stability, or the possibility of a lower interest rate on an ARM with a potentially more volatile index. Each lender operates with an index of his choice, and you most likely will not have an opportunity to negotiate over the index. If you want a particular index, it will be necessary for you to shop around among lenders until you find the one with which you are most comfortable.



Selected Indexes Used to Set Rates on Adjustable Rate Mortgages

(Annual Averages)

YEAR	1-Year[1] Treasury	3-Year[1] Treasury	5-Year[1] Treasury	Long Term[2] Fixed Rate Mortgages	FHLBB[3] Series of Closed Loans	S&L[4] Cost of Funds (Nat.)
1965	4.14%	4.22%	4.25%	5.74%	5.81%	4.24%
1966	5.20	5.23	5.10	6.14	6.25	4.52
1967	4.88	5.04	5.11	6.33	6.46	4.71
1968	5.69	5.68	5.70	6.83	6.97	4.74
1969	7.12	7.02	6.93	7.66	7.81	4.88
1970	6.90	7.29	7.38	8.27	8.45	5.30
1971	4.88	5.65	5.99	7.59	7.74	5.38
1972	4.96	5.72	5.98	7.45	7.60	5.41
1973	7.31	6.95	6.87	7.78	7.95	5.59
1974	8.18	7.82	7.80	8.71	8.92	6.14
1975	6.76	7.49	7.77	8.75	9.01	6.33
1976	5.88	6.77	7.18	8.76	8.99	6.38
1977	6.09	6.69	6.99	8.80	9.01	6.44
1978	8.34	8.29	8.32	9.30	9.54	6.67
1979	10.67	9.72	9.52	10.48	10.77	7.47
1980	12.05	11.55	11.48	12.25	12.65	8.94
1981	14.78	14.44	14.24	14.16	14.74	10.92
1982	12.27	12.92	13.01	14.47	15.12	11.38
1983	9.57	10.45	10.80	12.20	12.66	9.83

[1] Source: Federal Reserve Board

[2] Contract Rate on 25 + Year Fixed Rate Conventional New Home Loans.
Source: Annual Statistical Digest and Federal Reserve Bulletin.

[3] Average Effective Interest Rate on Conventional Loans Closed assuming prepayment at the end of 10 years.
Source: Annual Statistical Digest and Federal Reserve Bulletin.

[4] Averages of semi-annual numbers.
Source: Federal Home Loan Bank Board

Prepared by MBA Economics Department
August 1984

4

The Margin

The margin is an additional amount the lender adds to the index to establish the new rate at the time of each adjustment. It is expressed as a percentage.

In most ARMs, the margin is always the same percentage, and it is always added to the index whether the index goes up or down. There are some ARMs that feature a margin that is lower at the time of the first adjustment than it is at subsequent adjustments.

Different lenders charge different margins. Most lenders charge between one and three percentage points. The margin amount is also apt to be different for different types of ARMs. For example, the margin for an ARM that has an annual or lifetime interest rate cap may be higher than for an ARM that does not contain those features.

Remember, ***it is the index rate plus the margin that establishes your new interest rate.***

Most lenders have established their margins on the basis of what they believe is necessary to operate profitably, and they are reluctant to change the margin they require.

Advice on the Margin

It is in your best interest to negotiate for as low a margin as possible. This will keep your monthly payments lower, no matter what happens to the index. The amount of the margin may differ depending on what adjustment interval and other features you select. It will probably be necessary for you to "shop around" among different lenders for the best combination of index and margin.

Example of an ARM Containing Only the Four Basic Features[1]

Loan Amount	$50,000
Loan Term	30 years
Initial Interest Rate	12%
Adjustment Interval	Annually
Index	One-year Treasury security yield
Margin	1.5%[2]
Monthly Payment (not including taxes, insurance, and mortgage insurance premiums, if any) for the first year	$514.31
Assume that, at the end of the first year, the index is 13%. Add the index rate (13%) and the margin (1.5%) to get the new interest rate (14.5%).	
Because, during one year, you have paid $181.44 on your loan principal, your new rate will be figured on a balance of $49,818.56, and on a term of 29 years, because your loan is one year old.	
Your new monthly payment is	$611.33
Your monthly payment has increased	$97.02
If, however, the index rate had increased even more, say to 14%, your new interest rate (with the 1.5% margin) would be 15.5%, and your new monthly payment would have been	$650.97

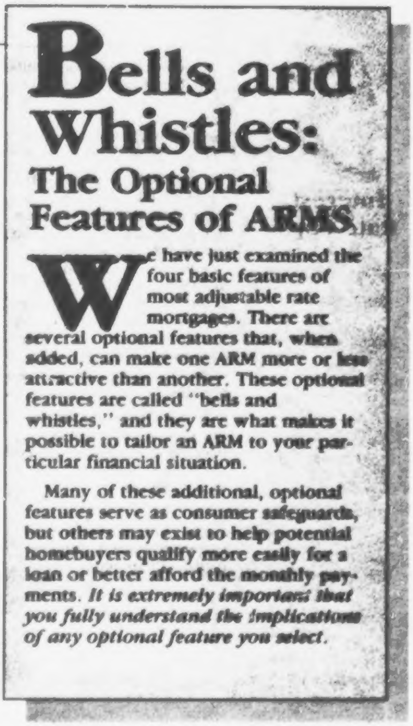
Remember that this type of ARM has no "cap" or limit on the amount your payment could increase. But do not forget that the interest rate could have come down.

This example illustrates that just a 2½% increase in the index over a one-year period can have a rather dramatic impact on your monthly payments. In discussing an ARM with your mortgage banker or other lender, make sure that you study several examples of interest rate changes and what they could do to your monthly mortgage payments, with or without interest rate caps or monthly payment caps.

Ask yourself whether you can afford to make the monthly mortgage payments that could occur in the ARM you select. The lender wants to make you a loan, and will help you determine your ability to afford the loan, based on generally accepted underwriting standards. But in the final analysis, you have to decide if you can afford to buy the home now, or perhaps should wait until a more favorable time in the future.

[1] The financial calculations presented here were computed on the HP-12C calculator set to an accuracy level of six decimal places.

[2] The margin of 1.5% is used simply for consistency's sake. You may pay closer to 2 or 2.5% for some types of ARMs.



Bells and Whistles:

The Optional Features of ARMS

We have just examined the four basic features of most adjustable rate mortgages. There are several optional features that, when added, can make one ARM more or less attractive than another. These optional features are called "bells and whistles," and they are what makes it possible to tailor an ARM to your particular financial situation.

Many of these additional, optional features serve as consumer safeguards, but others may exist to help potential homebuyers qualify more easily for a loan or better afford the monthly payments. *It is extremely important that you fully understand the implications of any optional feature you select.*

5

Interest Rate Caps

An interest rate cap limits how much the interest rate on your mortgage can increase or decrease at the time of each adjustment, or over the life of the loan.

The most common experience is that lenders who offer these optional features have a two percentage point limit on the amount the interest rate can increase at each adjustment and a five percentage point limit on how much the interest rate can increase over the life of the loan. You may have to pay a higher margin or initial interest rate for this protection.

An ARM with an interest rate cap cannot result in negative amortization unless there is also a monthly payment cap feature.

The interest cap is a consumer safeguard because it keeps payments within predictable limits and protects you against dramatic increases in your monthly payments. Even if the index rate, plus the margin, would establish a new rate in excess of the limit permitted by the interest rate cap on your loan, your payment would increase only to the limit permitted by the cap. The amount of interest lost by the lender because of interest rate caps is lost forever.

Advice on the Interest Rate Cap

Generally, it is to your advantage to obtain an ARM with an interest rate cap on both the amount the interest rate can increase at the time of each adjustment as well as over the life of the loan. The higher margin or higher initial interest rate you may have to pay could well be worth it.

We will use two examples to show what happens to an ARM with interest rate caps. The first example will be of an ARM with only an annual interest rate cap. The second example will be of an ARM with both an annual interest rate cap *and* a cap on the amount of interest that can be charged over the life of the loan. This way, we can show you the worst that can happen if you accepted an ARM with an initial rate of 12 percent that included these important consumer safeguards. You can substitute any rate for the 12 percent, and the examples will still work.

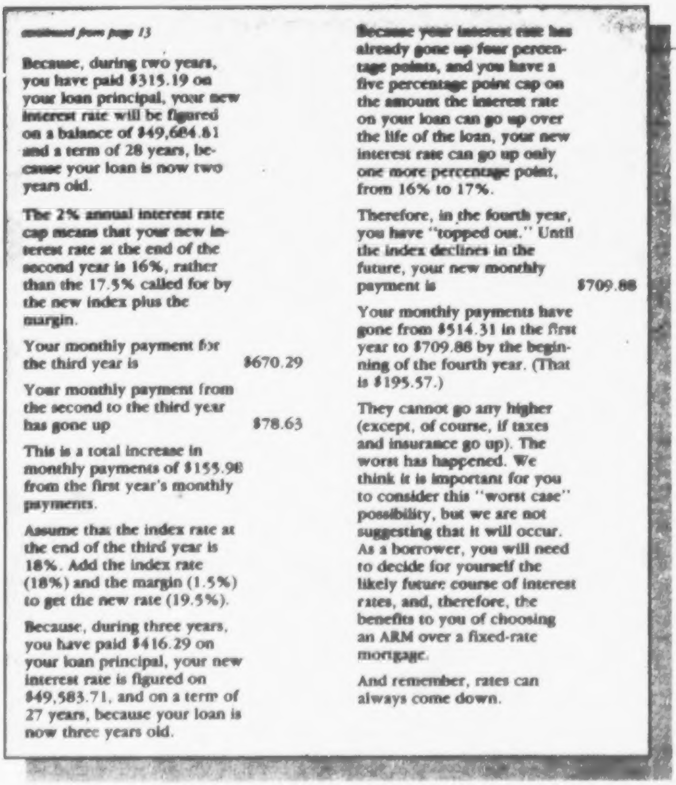
Example of an ARM with Annual Interest Rate Cap

Loan Amount	$50,000
Loan Term	30 years
Initial Interest Rate	12%
Adjustment Interval	Annually
Index	One-year Treasury security yield
Margin	1.5%
Interest Rate Cap	Yes, 2% annually
Monthly Payment (not including taxes, insurance, and mortgage insurance premiums, if any) for the first year	$514.31
Assume that, at the end of the first year, the index rate is 13%. Add the index rate (13%) and the margin (1.5%) to get the new interest rate (14.5%). Because, during one year, you have paid $181.44 on your loan principal, your new rate will be figured on a balance of $49,818.56 and on a term of 29 years because your loan is one year old.	
But, because you have a 2% annual interest rate cap, your interest rate can only go from 12% (the initial rate) to 14%, even though the new index rate (13%) plus the margin (1.5%) calls for a 14.5% rate.	
At 14%, your new monthly payment is now	$591.66
Your monthly payment on principal and interest has increased	$77.35
If you had not had the 2% annual cap on your interest rate, your new payment would have been based on the 14.5% rate called for by the new index (13%) plus the margin (1.5%), and would have been	$611.33
With a cap, you saved	$19.67
And you have no negative amortization.	
Remember, without a cap on the amount the interest rate can go up over the life of the loan, your interest rate could increase two percentage points each year.	

Example of an ARM With Both Annual Interest Rate Cap and a Cap on the Amount the Interest Rate Can Increase Over the Life of the Loan

Loan Amount	$50,000
Loan Term	30 years
Initial Interest Rate	12%
Adjustment Interval	Annually
Index	One-year Treasury security yield
Margin	1.5%
Interest Rate Cap	Yes, 2% annually; 5% over the life of the loan
Monthly Payment (not including taxes, insurance, and mortgage insurance premium, if any) for the first year	$514.31
Assume that, at the end of the first year, the index rate is 13%. Add the index rate (13%) to the margin (1.5%) to get the new rate (14.5%).	
Because, during one year, you have paid $181.44 on your loan principal, the new rate will be figured on $49,818.56, and on a term of 29 years because your loan is one year old. At 14.5%, your new monthly payment would have been	$611.33
But, because you have a 2% annual interest rate cap, your interest rate can only go from 12% to 14%. Therefore, at 14%, your actual monthly payment is now	$591.66
Assume that, at the end of the second year, the index rate is 16%. Add the index rate (16%) and the margin (1.5%) to get the new rate (17.5%).	

example continued on next page



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Because, during two years, you have paid $315.19 on your loan principal, your new interest rate will be figured on a balance of $49,684.81 and a term of 28 years, because your loan is now two years old.

The 2% annual interest rate cap means that your new interest rate at the end of the second year is 16%, rather than the 17.5% called for by the new index plus the margin.

Your monthly payment for the third year is $670.29

Your monthly payment from the second to the third year has gone up $78.63

This is a total increase in monthly payments of $155.98 from the first year's monthly payments.

Assume that the index rate at the end of the third year is 18%. Add the index rate (18%) and the margin (1.5%) to get the new rate (19.5%).

Because, during three years, you have paid $416.29 on your loan principal, your new interest rate is figured on $49,583.71, and on a term of 27 years, because your loan is now three years old.

Because your interest rate has already gone up four percentage points, and you have a five percentage point cap on the amount the interest rate on your loan can go up over the life of the loan, your new interest rate can go up only one more percentage point, from 16% to 17%.

Therefore, in the fourth year, you have "topped out." Until the index declines in the future, your new monthly payment is $709.88

Your monthly payments have gone from $514.31 in the first year to $709.88 by the beginning of the fourth year. (That is $195.57.)

They cannot go any higher (except, of course, if taxes and insurance go up). The worst has happened. We think it is important for you to consider this "worst case" possibility, but we are not suggesting that it will occur. As a borrower, you will need to decide for yourself the likely future course of interest rates, and, therefore, the benefits to you of choosing an ARM over a fixed-rate mortgage.

And remember, rates can always come down.

6
Monthly Payment Cap

The monthly payment cap is a limit on the amount by which the monthly mortgage payment can increase at each adjustment. A common payment cap is a monthly payment increase equal to an amount 7.5 percent greater than the previous year's monthly payment, regardless of what happens to the interest rate.

Loans with monthly payment caps can cause negative amortization to occur.

The monthly payment cap provides you with certainty about the maximum amount your monthly payment could go up each time your loan adjusts. But, by controlling the amount of your payment, you may not be paying enough to cover the interest that would have been charged if you had not selected the monthly payment cap feature. Remember that your ARM interest rate remains the indexed rate plus the margin, regardless of what you pay. The lender is permitted to add the unpaid interest to the outstanding balance of your original loan.

Be sure to read the explanation of negative amortization.

Advice on the Monthly Payment Cap

The good news is that the monthly payment cap can help you avoid even larger payment increases as a result of increasing interest rates. The bad news is that the resulting negative amortization makes it more difficult for you to build up equity (by paying down the loan balance) in your home. And, in fact, negative amortization can lead to you owing more on the loan than the original balance, even though you have made payments for several years. It might be well to consider a provision that limits the amount of negative amortization you can accumulate to 125 percent of the original loan amount. Many lenders, in fact, will not permit negative amortization to exceed 125 percent of the original loan amount.

Example of a Loan with a Monthly Payment Cap

Loan Amount	$50,000
Loan Term	30 years
Initial Interest Rate	12%
Adjustment Interval	Annually
Index	One-year Treasury security yield
Margin	1.5%
Interest Rate Cap(s)	No
Monthly Payment Cap	Yes, 7.5% annually
Negative Amortization	Yes
Monthly Payment (not including taxes, insurance, and mortgage insurance premium, if any) for the first year	$514.31

Assume that at the end of the first year, the index rate is 13%. Add the index rate (13%) and the margin (1.5%) to get the new rate (14.5%).

Because, during one year, you have paid $181.44 on your loan principal, your new rate will be figured on $49,818.56 and on a term of 29 years because your loan is one year old.

If you did not have a monthly payment cap, your new monthly payment would be	$611.33
But, because you do have a monthly payment cap that permits your payment to increase only by 7.5% over the previous year's monthly payment, your new monthly payment is actually	$552.88
The difference between what your monthly payment would have been if you did not have a monthly payment cap ($611.33) and what it actually is because you do have the cap ($552.88) is	$58.45
The amount of the unpaid interest is added to the principal balance each month. At the end of the second year, your new outstanding loan balance is	$50,448.46

That is more than you borrowed in the first place and is called negative amortization. But at least you controlled the maximum increase in your monthly mortgage payments.

7

Graduated Payments

The graduated payment feature of an ARM provides for lower initial monthly payments, which increase by an agreed-upon, predetermined percentage each year for a set period of time. At the end of that time, the monthly payments are then subject to adjustment according to the index and the margin on each adjustment date.

Most lenders who offer the graduated payment mortgage allow the monthly payment to increase each year by 7.5 percent over the previous year's monthly payment for a period of between three and 10 years, with the three- or five-year period being the most common.

The advantage to you is that the initial monthly payments are more affordable than payments on a standard fixed-rate mortgage, and you know exactly how much the payments are going to increase each year for a period of years.

However, during the period that the graduated payment schedule is in effect, any unpaid interest caused by the lower initial monthly payments is added to the outstanding balance of the loan, resulting in negative amortization. You are accumulating negative amortization because most often your payment schedule is set up so that the first few years' payments are not enough to cover the full cost of the interest due. This may make it easier for you to afford the monthly payments, but in reality you are simply postponing the payment of interest.

Even though your monthly payments increase by the set amount, your interest rate is tied to the index rate, which can go up or down. If the index plus margin is higher than the initial rate, you would be accumulating negative amortization.

Also, the graduated payment feature means the negative amortization you accumulate could reach the point where the lender will require you to recast your loan, increasing your payments to the level necessary to amortize the loan fully. This could happen before the end of the graduated payment period because few, if any, lenders will allow negative amortization to exceed 125 percent of the original loan balance.

Example of an ARM with a Graduated Payment Feature

Loan Amount	$50,000
Loan Term	30 years
Interest Rate	12%
Adjustment Interval	Annually
Index	One-year Treasury security yield
Margin	1.5%
Interest Rate Cap(s)	No
Graduated payments	Yes, 7.5% annually for five years
Negative Amortization	Yes
First Year's Monthly Payment	$595.69
Because your monthly payment does not cover the full amount of interest due, you have accumulated negative amortization in the first year of	$1,322.91
This makes your outstanding balance	$51,322.91
Your second year's monthly payment, which can go up only 7.5% because of the payment schedule established when you took out the loan, is	$425.37
Remember that under this type of graduated payment ARM, your "real" interest rate is determined by the index after the first year.	
Assume that at the end of the first year, the mortgage rate had gone to 13%.	
At the end of the second year you have additional unpaid interest of	$1,664.39
This makes your outstanding balance now	$52,987.31
Assume that by the end of the second year the mortgage rate had gone to 14%.	
At the end of the third year, with the mortgage rate at 14%, you would have additional unpaid interest of	$2,059.83
This would make your outstanding balance now	$55,047.14
However, your fourth year's monthly payment has gone up only 7.5% over the third year's monthly payment, to	$491.56
By the end of the fifth year, assuming the mortgage rate stayed at 14%, you would have additional unpaid interest of	$3,673.08
And your new outstanding loan balance, because of this negative amortization, would be	$58,720.22
However, your fifth year's monthly payment has gone up only 7.5% to	$528.43
At the end of five years, in this example, your period of gradually increasing payments is over, and your interest rate is now based on the index plus the margin, adjusted annually. If, as we have assumed already in this example, the index plus the margin is 14% at the end of the fifth year, then your monthly payment for the sixth year will be	$706.85
This is an increase of $178.42 from the monthly payments during the fifth year.	
Remember that if, at any time during the five year graduation period, your negative amortization had reached 125% of the original loan amount, your lender would have required that you adjust your monthly payments to a level sufficient to pay off the loan fully over the years remaining until the loan matures.	

8

Negative Amortization

When a monthly payment is not sufficient to cover all of the interest accruing (building up) and due on the loan, because of limits placed on how much the loan payments can increase, the result is negative amortization. As we have seen in the preceding examples, this means that the balance on your loan, instead of declining, actually increases during the early years of the loan. Under such circumstances, you can end up owing more than you borrowed, until your gradually rising payments overtake the accruing interest.

Most mortgage loans in the past called for equal monthly payments sufficient to pay off the principal and interest at the end of the loan term. However, because of the fluctuation in interest rates in recent years (which led to the development of adjustable rate mortgages) there is the possibility that the interest rates on ARMs could increase dramatically, thus increasing the monthly payment beyond the ability of a homeowner to pay. This could lead to delinquencies and foreclosure, something no one wants.

To avoid this kind of "payment shock," lenders developed several consumer safeguards. We have already explained two of those: the monthly payment cap and the graduated payment feature. Both can result in negative amortization.

Lenders usually will not allow negative amortization to exceed 125 percent of the original loan balance. If that happens, you will be required to adjust your mortgage payments upward to a level sufficient to amortize or pay off the new balance in full over the remaining term of the loan.

Borrowers always have the right voluntarily to increase their monthly payments to avoid negative amortization, after informing the lender of their intentions.

Advice on Negative Amortization

Although negative amortization always results in increasing the outstanding loan balance, sophisticated borrowers may realize there are certain advantages to this form of mortgage. If you live in an area where the value of housing is growing substantially above the percentage your outstanding loan balance is increasing yearly, then you can still look forward to a gain when you sell your house. And you will have been paying below-market interest rates for your mortgage while you lived in the house. This involves some guesswork about future housing prices, and consultation with your lender, friends, and others is advised before entering into this type of contract.

Generally, dealing with negative amortization involves risk. If, however, you are determined to buy a house, and it is the only way you can qualify for a loan, you should not reject negative amortization out of hand.

The following illustrates what can happen when monthly payment caps limit payment increases to less than those called for by normal amortization, so that negative amortization occurs. The illustration, therefore, is essentially the same as that shown under point 6, which discussed monthly payment caps.

Example of an ARM with Negative Amortization

Loan Amount	$50,000
Loan Term	30 years
Initial Interest Rate	12%
Adjustment Interval	Annually
Index	One-year Treasury security yield
Margin	1.5%
Interest Rate Cap	No
Monthly Payment Cap	Yes, 7.5% annually
Negative Amortization	Yes, unless 125% of original loan balance is reached.
Monthly Payments (not including taxes, insurance, and mortgage insurance premium, if any) for first year	$514.31
Assume that, at the end of the first year, the index is 13%. Add the index (13%) and the margin (1.5%) to get the new rate (14.5%) at which interest accrues. Because, over one year, you have paid $181.44 on your loan principal, the new interest rate will be figured on $49,818.56 and on a term of 29 years because your loan is one year old.	
Your new monthly payment would have been	$611.33
But, because you have a monthly payment cap that permits your payment to increase only by an amount equal to 7.5% of the previous year's monthly payment, your new monthly payment is actually	$552.88
The difference between what your monthly payment would have been if you did not have a monthly cap ($611.33) and what it actually is because you do have the cap ($552.88) is	$58.45

The interest that accrues each month is added to the outstanding balance of your loan, because your payment under the cap is not enough to cover the interest accruing on your loan. This results in negative amortization, causing the loan balance to increase rather than decrease. This can go on each year during the period of capped payments, assuming interest rates keep going up, and the yearly 7.5 percent increase in monthly payments is not enough to pay the accruing interest due. But most lenders will not permit the unpaid interest to exceed 125% of the original loan balance. If and when negative amortization causes the loan balance to reach 125% of the original loan balance ($62,500 = 125% of original loan balance of $50,000), your lender will require you to adjust your payment to a level sufficient to pay off the loan over the remaining loan term.

Remember that you always have the right voluntarily to increase your payment to avoid negative amortization.

9

The "Introductory" Rate

An "introductory" rate is an initial interest rate for an ARM that is lower than what the market would seem to require. These introductory rates are generally only one or one-and-a-half percentage points below the market for other ARMs. An introductory rate that is considerably lower than rates on other ARMs is called a "teaser" rate, because it is so low that it tempts homebuyers who might not be able to afford the higher rates that are certain to be charged a few years later, even if the index remains unchanged.

How low a teaser rate may be depends entirely on the lender. Some lenders have offered initial interest rates on their ARMs as low as four or five percent. Others regard a teaser rate as only one or two percentage points below the index rate.

In almost all cases, the teaser rate ARM will adjust upward at the first adjustment to the more normal rates, frequently with substantial increases in monthly payments.

A teaser rate loan may or may not be linked with an interest rate cap.

Advice on "Introductory" Rate ARMS

An introductory rate that is only one or one-and-a-half percentage points below market may not result in any hardship when it is adjusted upward and is most likely a good deal if you are able to meet the adjusted payments. It may also be good if you plan to move within a short period of time, because you will have gotten a below-market rate loan for a little while. If you do accept a "teaser" introductory rate loan, however, be sure you will have enough income to meet the substantially higher payments after the first adjustment.

Example of an "Introductory" Rate ARM

Loan Amount	**$50,000**
Loan Term	**30 years**
"Normal" Initial Interest Rate	**12%**
"Introductory" Rate	**10%**
Adjustment Interval	**Annually**
Index	**One-year Treasury security yield**
Margin	**1.5%**
Interest Rate Cap	**No**
Monthly Payment Cap	**No**
Negative Amortization	**No**
Monthly Payment (not including taxes, insurance, and mortgage insurance premium, if any) for the first year	**$438.79**
Assume that at the end of one year, the index rate is 13%. Add the index rate (13%) to the margin (1.5%) to get the new interest rate (14.5%).	
Because, after one year, you would have paid $277.94 on your loan principal, your new interest rate will be figured on $49,722.06, which would make your new monthly payment	**$610.14**
Your monthly payment has gone up after one year by	**$171.35**
It may be possible to obtain an "introductory" rate loan that has an interest rate cap applied against the initial interest rate. If that is the case, the increase in your monthly payments would not be as much as in this example.	

10

Assumability

Assumability allows a homeowner to transfer the mortgage on the property to a new homebuyer, usually at the same interest rate, if the buyer meets the credit guidelines of the lending institution that made the loan. It is most often the case that ARMs are assumable, because the interest rate being charged on them is always at or close to the current market rate, as determined by the index plus the margin.

The lender may require an adjustment to the interest rate upon assumption if the rate, for some reason, is not at the market level at the time you want to sell. In some cases, the payment of a fee is required. The fee is usually based upon the remaining outstanding balance of the loan.

Advice on Assumability

Assuming an adjustable rate loan can be advantageous, especially if the loan contains features that are generally unavailable from lenders in your area. But, typically, assuming an adjustable rate mortgage does not have the great advantages that assuming a below-market, fixed-rate loan once had. Still, it does not hurt to ask that a sentence permitting assumability be included in your mortgage contract.

11

Convertibility

Convertibility allows you to change an ARM to a fixed-rate mortgage, usually at the end of some predetermined period. Some lenders charge a fee, typically one percent of the outstanding balance of the loan, if you want to convert. The interest rate is then fixed for the remaining term of the mortgage at a level comparable with the prevailing interest rates for other long-term, fixed-rate mortgages.

Advice on Convertibility

Whether convertibility is really to your advantage depends on what happens to interest rates over time. Because that cannot be predicted with any certainty, you should decide to convert only if you are convinced that interest rates are going to rise above the current rate on your ARM, and stay there long enough for you to realize real savings by switching to the fixed-rate loan. As with assumability, it does not hurt to have convertibility included in your mortgage contract, if the lender is willing.

12

Prepayment Privilege

Prepayment allows the homeowner to pay off the loan balance in full before the end of the loan term. This usually occurs when a homeowner refinances the existing mortgage to obtain a more favorable interest rate, or when the house is sold. However, some lenders will require that a prepayment fee be paid. The fee is usually a small percentage of the outstanding loan balance. These fees are not allowed with Federal Housing Administration (FHA)-insured or Veterans Administration (VA) guaranteed loans.

Advice on Prepayment

Being able to prepay a loan without penalty makes it easier and less costly to refinance if that becomes necessary. Ask your lender to include a prepayment without penalty clause in your contract, or negotiate as low a fee as possible.

Federal Housing Administration (FHA) ARM

Now, for the first time, lenders are authorized to offer **ARMs** that are insured by the Federal Housing Administration (FHA). FHA pioneered the long-term, fixed-rate mortgage more than 50 years ago and now has developed an ARM that contains these important consumer safeguards:

- A cap on the interest rate adjustment of one percentage point each year and five percentage points over the life of the loan.
- The loan can be assumed under the same terms and conditions by another qualified borrower.
- There is no negative amortization.

Each year, the lender will check the most recent weekly index available 30 days before the adjustment date and add to it the amount of the margin (index plus margin equals the new interest rate). Unless your mortgage documents provide otherwise, the new interest rate will be rounded to the nearest 1/8th percent. This rate will become your interest rate for the next year unless it violates the rate cap. That is, the mortgage rate cannot change by more than one percentage point at any adjustment or by more than five percentage points from the first-year rate.

This means that under certain circumstances, the index may decrease, but your *new interest rate may* actually increase. This will happen *only* if the new index plus margin is still at least one percentage point higher than your present interest rate. This is illustrated in year four of the following example. (Decreases in excess of one percent will also be applied at the next adjustment date if the calculated interest rate remains at or below the rate you are paying.)

Year	Index +	Margin =	Calculated Interest Rate	New Interest Rate
1	N/A	N/A	N/A	12% (initial interest rate)
2	10.5	2.0	(10.5 + 2.0 = 12.5)	12.5%
3	14.5	2.0	(14.5 + 2.0 = 16.5)	13.5%
4	13.5	2.0	(13.5 + 2.0 = 15.5)	14.5%
5	13.5	2.0	(15.5 + 2.0 = 15.5)	15.5%

- **The lender and borrower in this example agreed to an initial interest rate of 12% for the first year and that the annual adjustments to the interest rate will be calculated using the index plus a margin of two percentage points.**
- **In year two, the calculated interest rate (index plus margin) is 12.5%. Because this is less than one percent above the initial interest rate, the new interest rate is 12.5%.**
- **In year three, the index increases 4.0% from 10.5 to 14.5, and the calculated interest rate is 16.5%. However, because of the 1.0% ceiling on interest rate increases, the new interest rate is only 13.5%.**
- **In year four, the index *decreases* 1.0% (from 14.5 to 13.5). After adding the margin, the calculated interest rate is 15.5%, which is again more than the existing interest rate (13.5%). Therefore, the new interest rate will increase up to the one percent ceiling. The new interest rate *increases* to 14.5%.**
- **In year five, the index and the calculated interest rate *remain the same* as the previous year. However, because the calculated interest rate (15.5%) is still more than the existing interest rate (14.5%), the new interest rate will increase up to the 1% ceiling. Therefore, the new interest rate *increases* to 15.5%.**

Some More Things You Need To Know

In addition to understanding the basic and optional features of ARMs, there are other things you need to know when you apply for a mortgage loan. What follows would apply equally to an ARM or a long-term, fixed-rate mortgage.

Points

A point is an amount equal to one percent of the principal amount of the loan. Points are charged by the lender to increase the yield on the mortgage loan to make it comparable with other types of investments.

Buydowns of Interest Rates

A buydown is just what its name implies. The homebuyer, or an interested third party, such as a relative or a home builder, puts up an amount of money sufficient to "buy" or obtain a lower-than-market mortgage interest rate from a lending institution. Depending on how much money is put up, the buydown can be for a short period of time, or for an extended period.

If the buydown is for a short period of time, then the mortgage interest rate will revert to a more normal level at the end of the buydown period.

A buydown on an ARM could be linked with an interest rate cap or any other feature of an ARM that you select.

Disclosure Statement

This is a highly detailed explanation of the specific loan for which you are applying. Lenders who are regulated by a Federal agency are required to give it to you. As we said earlier, however, even though all of the details of the loan may have been disclosed to you, it does not mean that you will understand those details immediately. So keep asking questions until you feel satisfied that you understand the important terms and conditions in your mortgage contract. Most lenders are going "beyond disclosure" to make certain all your questions are answered to your complete satisfaction and understanding.

Annual Percentage Rate (APR)

This is the cost of your loan, expressed as an annual percentage. Lenders are required by law to provide you with the APR calculation. To determine the APR, the lender must calculate all the financing charges paid by the borrower, including the interest paid on the loan, the loan origination fee, any points paid under certain circumstances, and the mortgage insurance premiums you may have to pay.

Mortgage Insurance

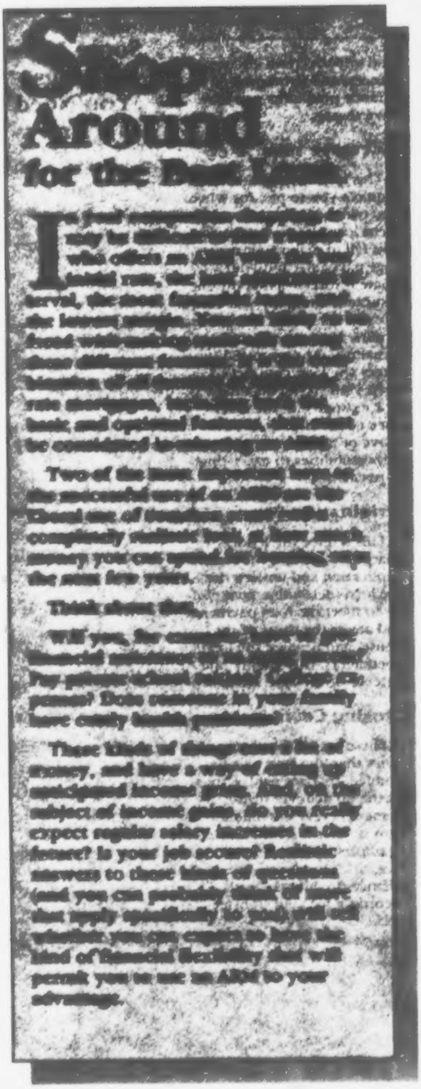
This is insurance the lender requires you to pay for when you take out a low downpayment loan. If, for any reason, you fail to make your mortgage payments and your home is foreclosed upon, the insurance company will compensate the lender if any loss occurs. However, it always remains your responsibility under the loan contract to keep your payments timely. The existence of the insurance contract does not remove or change any of your responsibilities to make timely payments.

Origination Fee

This is a fee the lender charges to process the loan application and underwrite the loan (determine your ability to meet the loan payments and assess the value of the house) and prepare the loan documents. It is usually one percent of the loan amount.

Closing Costs

These are all the costs, other than the loan origination fee, that are paid, either by the homebuyer or the home seller, at the time the loan is "closed," or finalized. Examples include lawyers' fees, title search fee, title insurance premiums, deed recording fee, and transfer tax.



Shop Around for the Best Loan

I[illegible] may be [illegible] who offers an ARM [illegible] lowest rate, the best [illegible] level, the most favorable terms and the lowest margin. [illegible] rate mortgages, [illegible] basic and optional features, that must be considered [illegible]

Two of the most important keys to the successful use of an ARM are the liberal use of [illegible] completely realistic look at how much money you can spend for housing over the next few years.

Think about that.

Will you, for example, have any large financial [illegible] in the near future? Pay private school tuition? College expenses? Does someone in your family have costly health problems?

These kinds of things cost a lot of money, and have a way of eating up anticipated income gains. And, on the subject of income gains, do you really expect regular salary increases in the future? Is your job secure? Realistic answers to these kinds of questions (and you can probably think of more that apply specifically to you) will tell whether you can expect to have the kind of financial flexibility that will permit you to use an ARM to your advantage.

Things to Consider

Make sure you know these things before you sign a contract for an ARM:

(Tear out this page and take it with you when you visit your mortgage banker or other lender.)

1	**Initial Interest Rate**	How low is it compared with the market rate, and how soon can it change? Has the rate been bought down?
2	**Adjustment Period**	Is it one, three, or five years? Is it another period?
3	**Index**	To what index will the ARM interest rate be tied? Is it a relatively stable rate, or does it fluctuate more than others?
4	**Margin**	What margin will be added to the index at each adjustment period?
5	**Interest Rate Caps**	How much can the rate change? How often? Will the cap apply to the first adjustment, or begin with a subsequent adjustment? Does the cap apply to a "teaser" rate or a buydown rate?
6	**Monthly Payment Cap**	Does the ARM have a payment cap? How much is it? When does it apply?
7	**Graduated Payments**	How much can your payments go up annually? Does it result in negative amortization? Is the initial interest rate fixed for the period of graduating payments?
8	**Negative Amortization**	Does the ARM allow negative amortization? How much negative amortization is allowed?
9	**"Introductory" Rate**	How much lower is the "introductory" rate than the "going" rate? When will it adjust? Is there a limit on how much the interest rate can go up at the time of adjustment?
10	**Assumability**	Can the ARM be transferred to another borrower? Is there a fee?
11	**Convertibility**	Can the ARM be converted to a fixed-rate mortgage without additional fees? Will the interest rate be higher or lower than the interest rate on the ARM?
12	**Prepayment Privilege**	Can the mortgage be paid off before the full term of the loan? Is a fee charged?
13	**Points**	How many points is the lender charging? Can the seller as well as the buyer pay them?

ARM Checklist	Lender 1	Lender 2	Lender 3	Lender 4	Lender 5	Lender 6
1. Initial Interest Rate						
2. Adjustment Interval						
3. Index						
4. Margin						
5. Interest Rate Caps						
6. Monthly Payment Cap						
7. Graduated Payments						
8. Negative Amortization						
9. "Introductory" Rate						
10. Assumability						
11. Convertibility						
12. Prepayment Privilege						
13. Points (Including origination fee)						

Tear out and use when shopping for an ARM

Senator Gorton. Barney, welcome.

STATEMENT OF B.R. BEEKSMA, CHAIRMAN OF THE BOARD AND PRESIDENT, INTERWEST SAVINGS BANK, OAK HARBOR, WA, ON BEHALF OF THE U.S. LEAGUE OF SAVINGS INSTITUTIONS

Mr. Beeksma. Thank you, Mr. Chairman, it is a pleasure to be here. My name is Barney Beeksma, speaking for the members of the U.S. League of Savings Institutions.

I have a prepared statement which I would like to enter into the record.

Senator Gorton. It will be.

Mr. Beeksma. I would like to supplement those comments with some personal comments from my own experience.

I am president of InterWest Savings Bank, located in Oak Harbor, WA. We were a pioneer in the use of what was called variable rate, but now adjustable rate mortgages. We used them exclusively for our own portfolio since 1969. Because of that, by the end of the 1970's, 90 percent of our portfolios was in adjustable rates. During that period we offered fixed rate mortgages along with those that we originated from our own portfolio.

My comments today are directed to my activity as a portfolio lender. The result of that activity, our own activity during 1981 and 1982, was that we remained profitable, we maintained a positive operating spread, and we continued to build our own reserves. We are continuing to grow and our present reserve position is among the top 10 percent in the entire country and well above the required level. The lending instrument which we used in those days was the one which was later adopted for wide use in California.

A more important consideration for these committees, however, is that during 1981 and 1982, we were always in the mortgage market with funds available.

RATE NEVER EXCEEDED 15 PERCENT

Our prime rate on ARM's never exceeded 15 percent during that time, when the rates on Freddie Mac loans, for example, peaked at somewhere around 19 percent. We were financing homes for home buyers when there was no money available, and people could not afford the fixed rate market. We've had considerable experience in both increasing and decreasing the rates on mortgages. Typically, when the increases are made, we get inquiries from only a very small percentage of those affected. The secret, of course, is proper disclosure up front, informing the buyers exactly what they are getting into.

When we initially developed our ARM, we set limits on the maximum adjustment which could be allowed, when we didn't have to do so. We have had numerous discussion sessions, group sessions, with prospective borrowers, and we find that uniformily, their most important consideration is some kind of a cap on the amount of change in the interest rate or payment which can occur in any 1 year.

A second consideration, and almost as important, is some kind of cap on the maximum adjustment allowed over the life of the loan.

From the practical standpoint, however, right now there are very, very few mortgages being offered in the market which have neither a cap on the payments nor the maximum adjustment during the life of the loan. Although Freddie Mac does offer such a plan, it is simply not being written, because it is not popular. Contrary to what you might hear, we are finding our borrowers are asking very, very intelligent questions about the makeup of ARM's.

I would be quick to confess that perhaps our borrowers are more intelligent than the average in the country, because, of course, they sent Slade Gorton to the U.S. Senate, but other than that, we think that probably that intelligence is increasing around the country and borrowers are becoming more and more knowledgeable.

Aside from Fannie Mae and Freddie Mac, from whom you have already heard, the most dominant influence in the mortgage markets today are the private mortgage insurance [PMI] companies. PMI companies are also active in this area, requiring both a cap on the actual payment change and the maximum change allowed over the life of the loan. Today they simply will not insure a no cap loan.

ASPECTS OF PAYMENT SHOCK

The question of payment shock has been raised. I submit to you that payment shock really comes from two sources. It was common practice a year or two ago to buy down the initial rate on an ARM to an unusually low or teaser rate. Buyers who took an initial rate of as low as either 6 or 7 percent or faced a substantial payment shock at the end of the buydown period, when the rate went to the market rate. That practice virtually has been eliminated, because customers now perceive it for what it is.

In addition, the PMI companies have maximum limits on the buydowns which are allowed. So that abuse has literally disappeared.

A second aspect of payment shock is that ARM's commonly use Treasury securities as an index, and Treasury securities tend to be quite volatile, particularly in the 1-year area. Without an annual adjustment cap, there very well could be some payment shock on loans that have already been written, when the interest rates accelerate rapidly.

The solution to eliminating payment shock is to eliminate excessive buydowns in the early years, which the marketplace has already done and to work toward more stable interest rates or finding a more stable index, in time, to develop these alternatives. Experience has shown that the marketplace will dictate what is good business for both the consumers and the lenders.

Many changes have come about already, simply through marketplace refinements. Borrowers are becoming more knowledgeable and they are shopping different lenders. Our experience indicates that lenders are only too happy to point out the shortcomings in their competitors' products. History simply has not established that there have been sufficient abuses in this area to require legislation. It is simply inappropriate that Congress should address the issue of legislating interest rates or maximum allowable changes in ARM's. It does not appear now that this area will be abused.

My concern is that times may change, and we may find that there is a need to adopt an ARM with a greater limit than 5 percent in variation. For example, if mortgage rates should drop 2 or 3 more percentage points, I think we will find many people leaving the mortgage market with ARM's, because we have seen mortgage rates go above 15 percent, and to initiate them at less than 10 will be crazy.

So, I think it would close the market, if we would set a 5-percent limit. What I am saying is, today we can live with 5 percent. There may be a time when we want to change that as an interest rate limit. Congress simply can't control interest rates, and so I think Congress should resist the temptation to try to legislate disciplines on those who have to work in an interest rate environment, unless Congress is willing to give us a guarantee that interest rates will not vary more than a certain percentage over the next 30 years. I feel it is inappropriate to legislate interest rates.

Thank you, Mr. Chairman.

[The complete prepared statement follows:]

STATEMENT OF B. R. BEEKSMA

ON BEHALF OF THE UNITED STATES LEAGUE OF SAVINGS INSTITUTIONS TO THE SENATE SUBCOMMITTEES ON FINANCIAL INSTITUTIONS & CONSUMER AFFAIRS AND HOUSING & URBAN AFFAIRS

April 19, 1985

CHAIRMEN AND MEMBERS OF THE SUBCOMMITTEES:

My name is B. R. Beeksma. I am Chairman of the Board and President of InterWest Savings Bank, Oak Harbor, Washington. I am pleased to appear before you today on behalf of the U.S. League of Savings Institutions* and its 3,400 savings and loan and savings bank members.

The U.S. League of Savings Institutions serves the more than 3,400 member institutions which make up the $1.1 trillion savings association and savings bank businesses. League membership includes all types of institutions -- federal- and state-chartered, stock and mutual. The principal officers include: John B. Zellars, Chairman, Atlanta, Georgia; Gerald J. Levy, Vice Chairman, Milwaukee, Wisconsin; William B. O'Connell, President, Chicago, Illinois; Philip Gasteyer, Executive Director of Washington Operations and Senior Vice President; and James O. Freeman, Senior Vice President and Senior Legislative Representative. League headquarters are at 111 East Wacker Drive, Chicago, Illinois 60601. The Washington Office is located at 1709 New York Avenue, N.W., Washington, D.C. 20006. Telephone: (202) 637-8900.

The subject of your hearing today is adjustable rate mortgages, widely known as ARMs. This is a subject of critical importance to savings institutions, and we are grateful to you for including us in this panel.

Before proceeding to an examination of the history of adjustable-rate mortgages, let me say that the U.S. League believes the adjustable rate mortgage is important...indeed, essential...to the continued ability of the savings institution industry to serve the mortgage credit needs of American homebuyers. Our industry has experienced broad marketplace acceptance of the adjustable-rate mortgage. (Indeed, my own institution, chartered by the State of Washington, has successfully offered ARMs for the past 15 years.) Furthermore, the U.S. League believes strongly that the marketplace should determine, through contracts freely entered into between informed borrowers and lenders, the terms and conditions of these conventional loans. In that regard, we have found that the marketplace has been continually evolving and improving as ARMs become accepted across the nation. Some practices, such as deep-discount "teaser" rates, are disappearing from the marketplace as consumers become more knowledgeable and lenders become more familiar with the ARM.

In that regard, our organization was disappointed when the Senate, by voice vote, adopted Amendment No. 3763 on motion by Senator Metzenbaum during its debate last September 12 on S. 2851, the Financial Institutions Competitive Equity Act. Fundamentally, as responsible financial intermediaries, we cannot accept a legislated 5% lifetime cap on mortgage rate adjustments as long as our source of funds, consumer deposits, is approaching total deregulation. (As a technical matter, we were somewhat unsure of the intended meaning in the Metzenbaum Amendment of the phrase "above the initial rate" from which the 5% was to be calculated; there would be a decidedly different impact if "initial rate" referred to the rate calculated as the Annual Percentage Rate disclosed under Truth-in-Lending to borrowers, the index rate from which adjustments up or down are determined, or the rate used for calculating the borrower's first monthly payment.)

The U.S. League strongly urges the distinguished Members of your Subcommittees and the full Banking, Housing and Urban Affairs Committee to reject last year's Metzenbaum Amendment or other statutory restraints on the marketplace development of ARMs as you work on financial services legislation in this 99th Congress.

The History of Adjustable Rate Mortgages

From the 1930s until recent years, the preponderance of mortgage loans provided for payment over a long term (25-30 years) and at an annual interest rate set for the entire term (a fixed rate). From the perspective of our institutions as portfolio lenders, this form of instrument worked well in the environment where regulations limited the amount of interest that savings institutions could pay on deposit accounts. The maximum allowable interest rate was carefully kept at a level lower than the market rate of interest for mortgage loans, as well as the average yield on all mortgages held in portfolio by all savings institutions. The spread between the cost of money and the earnings on that money was retained at a positive margin. The process worked smoothly so long as savings kept coming into savings institutions. But consumers were understandably not satisfied with the returns offered at our institutions in periods when higher returns were temporarily offered elsewhere. Thus, throughout the 1960's and 70's we experienced periods of severe disintermediation, or savings outflows by customers seeking the highest rate of return on their investments. At such times, the problem was not the cost of money, but the availability of funds for mortgage lending.

Deregulation of depository accounts was designed to meet this problem of disintermediation. Laws and regulations now permit savings institutions to pay a market rate of return on depository funds to attract the necessary share of available capital for mortgage financing. While the deregulation of accounts helps substantially in eliminating periods of disintermediation, savings institutions still face serious problems in dealing with periods of high interest rates.

When the economy is functioning in such a way that market interest rates are at high levels, savings institutions suffer. To attract funds, they must pay market rates of interest. However, the principal source of earnings for savings institutions is the mortgage portfolio which still contains a preponderance of fixed rate loans. Approximately 40% of the mortgages in savings institutions nationwide still carry coupon rates below 10%. Though this proportion has declined as institutions restructure to compete in today's deregulated savings environment, homeowners with bargain-rate loans are understandably reluctant to pay them off before maturity, and progress in upgrading portfolio yield is slow. Savings institutions remain inordinately exposed to interest rate risk. When their portfolios yield earnings below current market levels, savings institution operations are pushed into the red. Losses due to "below water" mortgage portfolios have been countered by savings institutions in two ways:

1. Increasing fee income through mortgage banking operations (that is, originating mortgage loans and selling them into the secondary market with a retention of servicing) and increased investment in shorter term, higher-yielding consumer and commercial lending activities.

2. Adjusting the mortgage portfolio to make it more compatible with varying market levels of interest rates by adding to portfolio ever increasing numbers of adjustable rate mortgages.

The problem with the first alternative is the difficulty of finding other investors willing to purchase the mortgage loans when savings institutions are not making such purchases. In fact, savings institutions are not significant net sellers of mortgage loans. In late 1982 and early 1983, because of an unique combination of circumstances and tax law, savings institutions did sell significant amounts of loans for a short period. Since that time, however, savings institutions have reverted to their traditional status as lenders which retain mortgages in portfolio. To be sure, a number of institutions do a great deal of mortgage banking business but the bulk of their sales customers are other savings institutions. In the aggregate, savings institutions are not mortgage banking loan sellers -- they make loans to hold. Mortgage banking is not a complete solution to our industry's systemic problem. Most important, it is essential to the housing policy of this country that thrift institutions be encouraged to remain portfolio housing lenders.

Though the secondary market may be able to provide supplemental assistance in tight markets, the added sources of mortgage finance from pension funds and insurance companies is truly marginal in relation to the funding provided by traditional portfolio lenders. If savings institutions are unable to make adjustable-rate loans to cover their variable savings costs, they will be unable to remain in the housing finance business. Even if thrifts are forced to make fixed-rate loans, they will run severe risks of enormous losses forcing them out of business entirely. Home borrowers faced with a dearth of mortgage lenders will then be offered totally unaffordable mortgage credit. It will do little good to mandate one form of mortgage credit if no credit at all is available.

The second alternative -- originating ARMs for portfolio -- has been the one adopted by most institutions. ARMs have varied widely, but developments in the ARM market show the efficiency of competitive pressures. Current types of mortgages reflect voluntary agreements by borrowers and lenders in highly competitive markets. One benefit of the less restrictive regulatory environment is the ability of borrower and lender to structure a contract which meets the needs of both. The adjustable rate mortgage is only one of the new loan types currently available, albeit the most important from our perspective.

In 1981 and 1982, when interest rates were very high, savings institutions found a good deal of borrower resistance to ARMs. Borrowers were familiar with and understood the fixed rate mortgage, wherein the interest rate risk was borne entirely by the lending institution. Although consumer savers were pleased, and even demanded, to receive a market rate on their savings deposits, consumer home borrowers were still reluctant to share any of the market risk on their mortgage loans.

Savings institutions found that to attract borrowers to ARMs they would have to promote the loans at initial, below-market rates. These promotions were made during 1983 and 1984 at a time when the market rate for traditional mortgages was generally on the increase. The more the rate on fixed rate mortgages increased beyond the affordable reach of borrowers, the more these borrowers turned to ARMs. The total mortgage lending volume of our industry set a record, $165.2 billion in 1984; approximately 85% of that volume was adjustable-rate loans. The driving force of mortgage activity for the savings institution industry last year was the success of the adjustable rate mortgage. The lower initial interest rates on ARMs kept the market alive during the early part of the year and again in mid-autumn when interest rates on fixed-rate loans were at levels which shut buyers out of the housing market. As interest rates subsided in these first months of 1985, the percentage of ARMs has declined somewhat, and fixed-rate loans increased, though the adjustable mortgages remain the dominant method of financing homes by our institutions.

The Importance of ARMs to the Housing Market

Without the ARM, housing activity would have been nearly as depressed in 1984 as it was in 1981 and 1982. Fragile consumer confidence and the lower prospect of near term returns on investment in a home would not have allowed fixed rate mortgage financing to produce the volumes of both new and existing home sales which we have recently experienced.

Fixed rate mortgage levels of around 14% appear to shut down the mortgage loan window completely. As outlined before, previous mortgage market crunches were produced by disintermediation and credit unavailability. Since 1980, funds have been theoretically available but few could afford to pay the price.

The ARM has taken some of the inflation and uncertainty premium out of mortgage interest rates. Since lenders can expect the loan rate to adjust in line with market conditions later, there is less need to charge a higher rate initially. In more technical terms, the ARMs are priced off a lower segment of the yield curve. More practically, ARMs are more affordable to many borrowers. The lower ARM rate provides a significant cushion against subsequent rate changes vis-a-vis the payments which would have been due on fixed rate loans. Many lenders have added a temporary discount to help out with the initial strains on a family's finances from the inevitable added expenses in the first few months of occupying a new home.

These rate discounts are a clear benefit to the borrower. We would emphasize that there is no community in the country where borrowers do not still have the option of fixed rate financing for their new home. Most mortgage bankers and some portfolio lenders continue to offer such loan terms. The market penetration of adjustable rate loans and other non-standard loan types thus reflects borrower awareness of the benefits of these alternatives to the traditional form of loan. These contracts are freely arrived at by both lenders and increasingly sophisticated borrowers to the advantage of both. The idea that what a lender gains the borrower must lose assumes that the transaction is a "zero sum game." As with most economic transactions, this is not the case with the ARM.

Consumer Advantages and Risk-Sharing with ARMs

Beyond the discounted initial rate, many consumers are finding ARMs appealing for other reasons. Borrowers, of course, retain the option to refinance at a time of their choosing if market conditions should improve dramatically (taking into consideration the costs of a second loan closing). Customarily, ARM financing allows prepayment without penalty -- enhancing the refinancing option. The adjustable mortgage is also assumable by another credit-worthy borrower. This is a very important feature which should be appreciated by anyone who has been faced with selling a home during a high interest-rate or credit-crunch period when it can be very difficult for a prospective buyer to obtain acceptable financing. In addition, some ARMs are being written with what is known as a "portability" feature; that is, the homeowner who must move to another residence for job or other reasons may apply their ARM to a new property.

Both borrowers and lenders have an interest in constructing loan agreements which do not produce a high risk of default. Mortgage foreclosure expenses eat heavily into the investment which both parties have in the mortgaged property. Portfolio lenders are keenly interested in the soundness of the underwriting standards for every loan they make.

Of course, there is the theoretical potential for credit losses and foreclosures on any type of mortgage. If general economic conditions sour, losses on even fixed rate mortgages increase when families lose one or even two income sources. That was the case in recession of 1981 and 1982; the increase in default was on fixed-rate loans.

As yet, there is no persuasive evidence of unmanageable or even significantly increased losses from adjustable rate loans in general. Some observers point to the increased borrower delinquency experience with the graduated payment mortgage (GPM) and builder-buy down mortgages as indicators of the disturbing trend, but these transactions are not necessarily comparable to ARMs.

The GPM was based on an assumption of continuing inflationary increases in real estate values not tied to overall changes in economic conditions. In addition, many of these loans are FHA-insured and, for two reasons, the default rate on such loans tends to be significantly higher than on conventional ARM loans made by traditional portfolio lenders. First, the financial prospects of GPM borrowers tend to be less solid. Second, such loans tend to be sold in the secondary market to remote investors which, unlike the local community savings institution, cannot negotiate over and forbear on the obligations of a borrower in temporary financial difficulty. (Members of your distinguished Subcommittee may recall testimony at your 1983 hearings on emergency mortgage relief to the effect that forbearance was far more likely with a conventional loan from a supervised depository institution portfolio lender.)

However, there is a positive relationship between loan payments and economic conditions on portfolio adjustable rate loans tied to open market indices which should provide positive correlation between the borrower's payment and income levels.

Portfolio lenders have no incentive to make bad loans. The situation can be less clear in circumstances where making the home sale is the key goal. Developer "buy-downs" of financing recaptured in inflated sales prices could produce higher-than-average foreclosure rates even if fixed rate loan terms are offered. There is no way to avoid some risk of the ultimate homebuyer's tragedy of foreclosure and loss of the family's residence. Portfolio lenders, however, have no incentive to run that risk, any more than the borrower does. In fact, the entire real estate sector -- builder, Realtor, and borrower -- is currently benefitting from the attempts of portfolio lenders to design more equitable types of loan structures.

Because of the need to avoid collection problems and the need to market a loan to borrowers, most lenders have incorporated a variety of interest rate or payment "caps" into their ARM products. Table 1 attached to this statement illustrates, in a simplified way, how "caps" work with ARM loans. The chart shows why it is not all that obvious that a fixed rate mortgage at today's 13% rate is a "better deal" than an adjustable at 11% initially -- even if interest rates increase significantly over a five year period. Indeed, the ARM borrower in the table will "break even", assuming interest rates and the ARM's index-plus-margin rate increase 1% for each of second through fifth years. (Such a scenario implies a return to rampant inflation, soaring housing prices, and, in many instances, cost-of-living increases for the borrower - a scenario we devoutly hope will not be realized if the Senate and the Congress act decisively on our federal deficit.)

"Caps" of various kinds are in common use with adjustable-rate mortgages in our industry. There are lifetime limits in upward interest-rate adjustments; there are annual limits; and there are limits on adjustments in monthly payments at periodic intervals. The amount of adjustment is determined by a variety of indices usually available for reference by borrowers from published sources. The one-year U.S. Treasury constant maturity index, the Federal Home Loan Bank District cost-of-funds index, and the national average mortgage contract rate index published by the Federal Home Loan Bank Board are three indices frequently used in ARM contracts. The Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation also influence ARM practices by announcing the term of the ARMs eligible for their secondary market purchase programs.

Some lenders have been willing to offer substantial protection against unaffordable payment increases by permitting increases in interest to be deferred and added to the loan balance. (This theoretically can create "negative" amortization on mortgage loans; such amortization can occur when, to cushion the borrower's cash outlays, the mortgage payment is not raised sufficiently to cover the interest on the loan balance computed at a new interest rate level.) Extensive computer simulations and analyses show that such limits are not likely to be exceeded even under interest-rate conditions similar to the volatile 1979-1983 period. (Of course, in every case, because there are no prepayment charges on ARMs, borrowers retain the option of voluntarily increasing payments to avoid accumulation of such deferred interest expense.) Savings institutions can handle their cash flow risk by deferring the collection of a cash payment to cover the periodic interest expense on the loan: the borrower is assisted by the fixed nature of the payment obligation on the loan for long segments of the loan term. Such risk sharing between the lender and the borrower is sensible.

Indeed such sharing is essential if the traditional source of mortgage finance for the average family and community -- specialized savings institutions -- remain open at all. Congress mandated the payment of open market rates on all savings accounts in 1980. That process is essentially complete. Now that the liabilities side is at market, the asset side must be flexible too. Savings institutions need to be able to design loan products which will work.

Not surprisingly, I would contend that there is no substitute for maintaining a healthy specialized savings institutions system for mortgage finance. While we encourage new techniques, such as mortgage securitization, there is no assurance that new sources will find mortgage finance advantageous in all economic environments, just as general-purpose lenders such as commercial banks or insurance companies have been in-and-out contributors to the mortgage market over the years. Savings institutions remain available, because of their repayment flows, to finance homes even in periods of credit stringency.

"Payment Shock" and Sound ARM Underwriting

As noted, it is neither in the borrower's or the lender's interest for loans to become delinquent, leading to possible foreclosures. As predominantly portfolio lenders, savings institutions are particularly sensitive to the mortgage underwriting aspects of home purchases. This is just as true with adjustable-rate mortgages as it was with fixed-rate loans. All savings institutions in my experience underwrite loans by comparing an applicant's income and creditworthiness to the initial indexed rate on ARMs, even if a lower or "discounted" rate applies to the early payments. This precaution against "payment shock" is reflected in a policy statement last September by the Federal Home Loan Bank Board, Memorandum #R-61, which reads in part:

> "Interest rate changes may lead to steep increases in payment burdens and subsequent delinquencies if borrowers are originally qualified at the discounted rate with high payment-to-income ratios. The steeper the rate discount, the larger the periodic rate change cap or the higher the qualifying income ratio, the more likely the possibility of a delinquency. It is important that institutions assess a borrower's ability to qualify by measuring current income against the projected adjusted payments which will result from the interest rate change."

Knowledgeable ARM Consumers

The U.S. League believes that it is important for loan customers to understand the financing terms of their home purchase, since for many families this may well be their single biggest lifetime investment. In this regard we were pleased to participate in the development of a consumer education pamphlet suggested last summer by the leadership of the House Banking Committee and its Housing and Community Development Subcommittee. The Consumer Handbook on Adjustable Rate Mortgages, attached to this statement, was prepared jointly by the Federal Reserve Board and the Federal Home Loan Bank Board. As you will note from the inside front cover, the booklet was prepared in consultation with other federal agencies, the leading depository institution trade groups, home builder and realtor organizations, and consumer organizations. The booklet is particularly helpful in explaining common ARM terms.

It is our understanding, as this statement is being prepared, that the Federal Home Loan Bank Board will require by regulation the distribution of the handbook to mortgage loan customers at all Federal Home Loan Bank System member institutions. I can report to your Subcommittees that almost a million of these handbooks have already been sent to the member institutions of the U.S. League.

While we applaud the development and distribution of the handbook, the U.S. League has reservations about another current proposal for consumer information on ARMs: a rigid, mandatory requirement to provide loan applicants with a "worst-case" scenario for ARM loans as part of Truth-in-Lending disclosures. Since the theoretical "worst case" possibility is highly unlikely to be realized, we question whether its distribution is at all helpful with the "shopping for credit" purposes sought by Truth-in-Lending disclosures. Furthermore, as our simplified comparison in Table 1 demonstrates, there are many instances where today's market-determined ARMs are superior to fixed-rate loans. It would be indeed unfortunate if borrowers were convinced by a "worst case" disclosure to enter into a more expensive fixed-rate mortgage loan.

Conclusion

To sum up, Mr. Chairman, the U.S. League is pleased to have had this opportunity to discuss adjustable rate mortgages once again with your distinguished Subcommittees. We cannot help but wonder if the condition of our industry today might be far stronger if the Congress had not interfered with the general introductions of flexible home mortgages in 1974. To your credit in the late-70's, the Senate Banking Committee took the lead in encouraging the development of ARMs by private-sector mortgage lenders. Adjustable-rate mortgages are essential to the future health of our specialized savings institutions, particularly those which emphasize the role of portfolio lenders committed to the long-term credit needs of households. Widespread use of ARMs sustained the housing recovery throughout 1984. Consumers, too, are benefitting from the broader selection of conventional mortgages made possible by ARMs. While we acknowledge that there have been some problems with certain types of variable loans, particularly the graduated payment mortgages, the marketplace is constantly improving the ARM mortgage product and consumers - with such new tools as the Consumer Handbook - are becoming ever more knowledgeable in choosing the best mortgage for their home purchase needs.

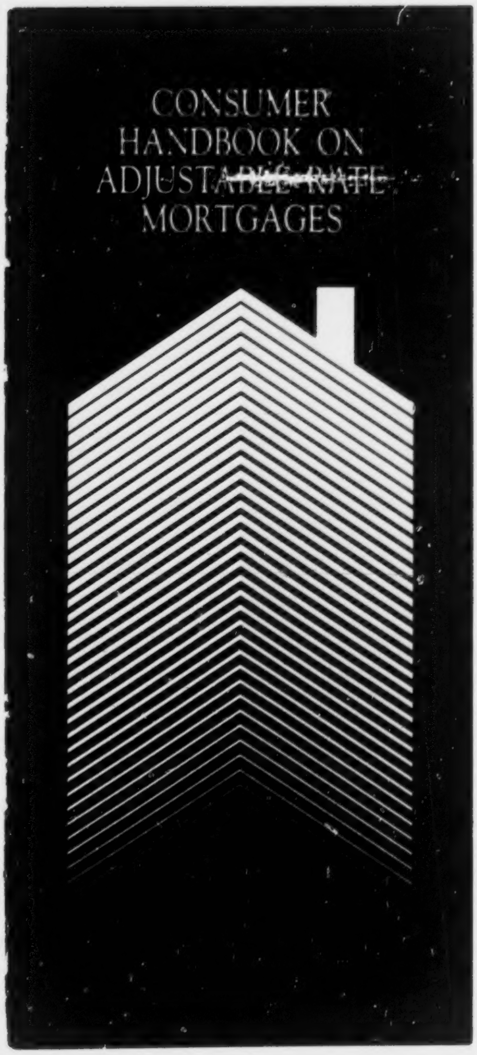
It would be most unfortunate if the Congress, through adoption of statutory restraints such as last year's Metzenbaum Amendment, were to interfere with this salutory progress in developing adjustable rate mortgages. Market-determined adjustable-rate mortgages are essential if we are to maintain our enviable position as a nation of homeowners.

I would be pleased to respond to any questions you might have at the appropriate time.

Table I

COMPARING ADJUSTABLE AND FIXED-RATE HOME MORTGAGES

Basic features	Fixed rate mortgage	Adjustable rate mortgage
1. Initial interest rate	13.0%	11.0%
2. Interest rate adjustment period	None	Annual
3. Payment adjustment period	None	Annual
4. Lifetime interest rate cap	13.0%	15.0%
5. Annual payment cap	Not applicable	7 1/2% or down
6. Principal additions (deferred interest)	None	Permitted
7. Prepayment penalty	Probable	None
8. Assumability	None	Permitted
9. Portability	None	Permitted
10. Qualifying rate	13.0%	11.0%
Impact of changing interest rates		
11. Mortgage amount	$65,000	$65,000
12. Initial monthly payment (principal and interest)	$719.03	$619.01
13. Average monthly payment over first five years:		
a) If interest rates stay the same	$719.03	$619.01
b) If interest rates increase 1%/year	$719.03	$715.55
c) If interest rates decrease 1%/year	$719.03	$527.12
14. Average interest rate over first five years:		
a) If interest rates stay the same	13%	11%
b) if interest rates increase 1%/year	13%	13%
c) If interest rates decrease 1%/year	13%	9%



CONSUMER HANDBOOK ON ADJUSTABLE RATE MORTGAGES

This booklet was prepared in consultation with the following organizations:

American Bankers Association
Comptroller of the Currency
Consumer Federation of America
Credit Union National Association, Inc.
Federal Deposit Insurance Corporation
Federal Reserve Board's Consumer Advisory Council
Federal Trade Commission
Independent Bankers Association of America
Mortgage Bankers Association of America
Mortgage Insurance Companies of America
National Association of Federal Credit Unions
National Association of Home Builders
National Association of Realtors®
National Council of Savings Institutions
National Credit Union Administration
Office of Special Advisor to the President for Consumer Affairs
The Consumer Bankers Association
U.S. Department of Housing and Urban Development
U.S. League of Savings Institutions

With special thanks to the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation

The Federal Reserve Board and the Federal Home Loan Bank Board have prepared this booklet on adjustable rate mortgages (ARMs) in response to a request from the House Committee on Banking, Finance and Urban Affairs and in consultation with many other agencies and trade and consumer groups. It is designed to help consumers understand an important and complex new product available to home buyers.

We believe a fully informed consumer is in the best position to make a sound economic choice. If you are buying a home, and looking for a home loan, this booklet will provide useful basic information about ARMs. It cannot provide all the answers you will need, but we believe it is a good starting point.

PEOPLE ARE ASKING . . .

"Some newspaper ads for home loans show surprisingly low rates. Are these loans for real, or is there a catch?"

Some of the ads you see are for adjustable-rate mortgages (ARMs). These loans may have low rates for a short time—maybe only for the first year. After that, the rates can be adjusted on a regular basis. This means that the interest rate and the amount of the monthly payment can go up or down.

"Will I know in advance how much my payment may go up?"

With an adjustable-rate mortgage, your future monthly payment is uncertain. Some types of ARMs put a ceiling on your payment increase or rate increase.

"Is an ARM the right type of loan for me?"

That depends on your financial situation and the terms of the ARM. ARMs carry risks in periods of rising interest rates, but can be cheaper over a longer term if interest rates decline. You will be able to answer the question better once you understand more about adjustable-rate mortgages. This booklet should help.

Mortgages have changed, and so have the questions that need to be asked and answered.

Shopping for a mortgage used to be a relatively simple process. Most home mortgage loans had interest rates that did not change over the life of the loan. Choosing among these fixed-rate mortgage loans meant comparing interest rates, monthly payments, fees, prepayment penalties, and due-on-sale clauses.

Today, many loans have interest rates (and monthly payments) that can change from time to time. To compare one ARM with another or with a fixed-rate mortgage, you need to know about indexes, margins, discounts, caps, negative amortization, and convertibility. You need to consider the maximum amount your monthly payment could increase. Most important, you need to compare what might happen to your mortgage costs with your future ability to pay.

This booklet explains how ARMs work and some of the risks and advantages to borrowers that ARMs introduce. It discusses features that can help reduce the risks and gives some pointers about advertising and other ways you can get information from lenders. Important ARM terms are defined in a glossary on page 19. And a checklist at the end of the booklet should help you ask lenders the right questions and figure out whether an ARM is right for you. Asking lenders to fill out the checklist is a good way to get the information you need to compare mortgages.

WHAT IS AN ARM?

With a fixed-rate mortgage, the interest rate stays the same during the life of the loan. But with an ARM, the interest rate changes periodically, usually in relation to an index, and payments may go up or down accordingly.

Lenders generally charge lower initial interest rates for ARMs than for fixed-rate mortgages. This makes the ARM easier on your pocketbook at first than a fixed-rate mortgage for the same amount. It also means that you might qualify for a larger loan because lenders sometimes make this decision on the basis of your current income and the first year's payments. Moreover, your ARM could be less expensive over a long period than a fixed-rate mortgage—for example, if interest rates remain steady or move lower.

Against these advantages, you have to weigh the risk that an increase in interest rates would lead to higher monthly payments in the future. It's a trade-off—you get a lower rate with an ARM in exchange for assuming more risk.

Here are some questions you need to consider:

- Is my income likely to rise enough to cover higher mortgage payments if interest rates go up?
- Will I be taking on other sizable debts, such as a loan for a car or school tuition, in the near future?
- How long do I plan to own this home? (If you plan to sell soon, rising interest rates may not pose the problem they do if you plan to own the house for a long time.)
- Can my payments increase even if interest rates generally do not increase?

HOW ARMS WORK: THE BASIC FEATURES

The Adjustment Period

With most ARMs, the interest rate and monthly payment change every year, every three years, or every five years. However, some ARMs have more frequent interest and payment changes. The period between one rate change and the next is called the adjustment period. So, a loan with an adjustment period of one year is called a one-year ARM, and the interest rate can change once every year.

The Index

Most lenders tie ARM interest rate changes to changes in an "index rate." These indexes usually go up and down with the general movement of interest rates. If the index rate moves up, so does your mortgage rate in most circumstances, and you will probably have to make higher monthly payments. On the other hand, if the index rate goes down your monthly payment may go down.

Lenders base ARM rates on a variety of indexes. Among the most common are the rates on one-, three-, or five-year Treasury securities. Another common index is the national or regional average cost of funds to savings and loan associations. A few lenders use their own cost of funds, over which—unlike other indexes—they have some control. You should ask what index will be used and how often it changes. Also ask how it has behaved in the past and where it is published.

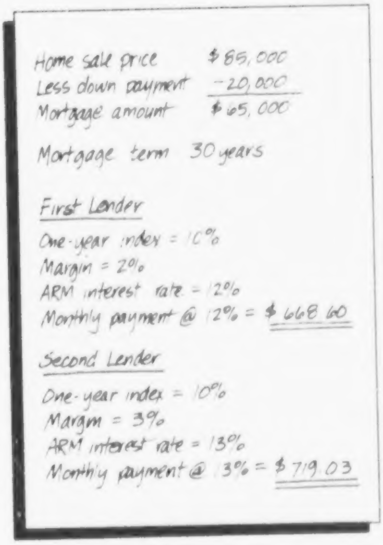
The Margin

To determine the interest rate on an ARM, lenders add to the index rate a few percentage points called the "margin." The amount of the margin can differ from one lender to another, but it is usually constant over the life of the loan.

Index rate + margin =
ARM interest rate

Let's say, for example, that you are comparing ARMs offered by two different lenders. Both ARMs are for 30 years and an amount of $65,000. (All the examples used in this booklet are based on this amount for a 30-year term. Note that the payment amounts shown here do not include items like taxes or insurance.)

Both lenders use the one-year Treasury index. But the first lender uses a 2% margin, and the second lender uses a 3% margin. Here is how that difference in margin would affect your initial monthly payment.



Home sale price $85,000
Less down payment -20,000
Mortgage amount $65,000

Mortgage term 30 years

First Lender

One-year index = 10%
Margin = 2%
ARM interest rate = 12%
Monthly payment @ 12% = $668.60

Second Lender

One-year index = 10%
Margin = 3%
ARM interest rate = 13%
Monthly payment @ 13% = $719.03

In comparing ARMs, look at both the index and margin for each plan. Some indexes have higher average values, but they are usually used with lower margins. Be sure to discuss the margin with your lender.

CONSUMER CAUTIONS

Discounts

Some lenders offer initial ARM rates that are lower than the sum of the index and the margin. Such rates, called discounted rates, are often combined with large initial loan fees ("points") and with much higher interest rates after the discount expires.

Very large discounts are often arranged by the seller. The seller pays an amount to the lender so the lender can give you a lower rate and lower payments early in the mortgage term. This arrangement is referred to as a "seller buydown." The seller may increase the sales price of the home to cover the cost of the buydown.

A lender may use a low initial rate to decide whether to approve your loan, based on your ability to afford it. You should be careful to consider whether you will be able to afford payments in later years when the discount expires and the rate is adjusted.

Here is how a discount might work. Let's assume the one-year ARM rate (index rate plus margin) is at 12%. But your lender is offering a 10% rate for the first year. With the 10% rate, your first year monthly payment would be $570.42.

But don't forget that with a discounted ARM, your low initial payment will probably not remain low for long, and that any savings during the discounted period may be made up during the life of the mortgage or be included in the price of the house. In fact, if you buy a home using this kind of loan, you run the risk of . . .

Payment Shock

Payment shock may occur if your mortgage payment rises very sharply at the first adjustment. Let's see what happens in the second year with your discounted 10% ARM.

ARM Interest Rate	Monthly Payment
First year (w/discount) 10%	$570.42
2nd year @ 12%	$667.30

As the example shows, even if the index rate stays the same, your monthly payment would go up from $570.42 to $667.30 in the second year.

Suppose that the index rate increases 2% in one year and the ARM rate rises to a level of 14%.

ARM Interest Rate	Monthly Payment
First year (w/discount) 10%	$570.42
2nd year @ 14%	$767.67

That's an increase of almost $200 in your monthly payment. You can see what might happen if you choose an ARM impulsively because of a low initial rate. You can protect yourself from increases this big by looking for a mortgage with features, described next, which may reduce this risk.

HOW CAN I REDUCE MY RISK?

Many ARMs have "caps" that protect borrowers from extreme increases in interest rates or monthly payments. Others allow borrowers to convert an ARM to a fixed-rate mortgage. While these may offer real benefits, they may also cost more, or add special features, such as negative amortization.

Interest-Rate Caps

An interest-rate cap places a limit on the amount your interest rate can increase. A cap is like insurance, so ARMs with caps may cost more than ARMs without them. Interest caps come in two versions:

- Periodic caps, which limit the interest-rate increase from one adjustment period to the next; and
- Overall caps, which limit the interest-rate increase over the life of the loan.

An ARM may have both a periodic and an overall interest rate cap.

Let's suppose you have an ARM with a periodic interest rate cap of 2%. At the first adjustment, the index rate goes up 3%. The example shows what happens.

ARM Interest Rate	Monthly Payment
First year @ 12%	$668.60
2nd year @ 15% (without cap)	$820.43
2nd year @ 14% (with cap)	$769.16

Difference in 2nd year between payment with cap and payment without = $51.27

A drop in interest rates does not always lead to a drop in monthly payments. In fact, with some ARMs that have interest rate caps, your payment amount may *increase* even though the index rate has stayed the same or declined. This may happen after an interest rate cap has been holding your interest rate down below the sum of the index plus margin.

With some ARMs, payments may increase even if the index rate stays the same or declines.

Look below at the example where there was a periodic cap of 2% on the ARM, and the index went up 3% at the first adjustment. If the index stays the same in the third year, your rate would go up to 15%.

ARM Interest Rate	Payment
First year @ 12%	$668.60
If index rises 3%	
2nd year @ 14% (with 2% rate cap)	$769.16
If the index stays the same for the	
3rd year @ 15%	$820.00
Even though index stays the same in 3rd year, payment goes up $50.84	

In general, the rate on your loan can go up at any scheduled adjustment when the index plus the margin is higher than the rate you are paying before that adjustment.

An ARM might also have an overall rate cap. The next example shows how a 5% overall rate cap would affect your loan. Let's say that the index rate increases 1% in each of the first ten years:

ARM Interest Rate	Monthly Payment
First year @ 12%	$668.60
10th year @ 21% (without cap)	$1,121.51
10th year @ 17% (with cap)	$919.91

With a 5% overall cap, your payment would never exceed $919.91, no matter how much rates continue to rise.

Payment Caps

Some ARMs include payment caps, which limit your monthly payment increase at the time of each adjustment, usually to a percentage of the previous payment. In other words, with a 7½% payment cap, a payment of $100 could increase to no more than $107.50 in the first adjustment period, and to no more than $115.56 in the second.

Let's assume that your rate changes in the first year by 2 percentage points, but your payments can increase by no more than 7½% in any one year. Here's what your payments would look like:

ARM Interest Rate	Payment
First year @ 12%	$668.60
2nd year @ 14% (without payment cap)	$769.16
2nd year @ 14% (with 7½% payment cap)	$718.75

Difference in monthly payment = $50.41 per month

Many ARMs with payment caps do not have periodic interest rate caps.

Negative Amortization

Be sure to find out about "negative amortization" if your ARM contains a payment cap. Negative amortization means the mortgage balance is increasing. This occurs whenever your monthly mortgage payments are not large enough to pay all of the interest due on your mortgage.

Because payment caps limit only the amount of payment increases, and not interest-rate increases, payments sometimes do not cover all of the interest due on your loan. This means that the interest shortage in your payment is automatically added to your debt, and interest may be charged on that amount. You might therefore owe the lender more later in the loan term than you did at the start. However, an increase in the value of your home may make up for the increase in what you owe.

The next illustration uses the figures from the preceding example to show how negative amortization works during one year. Your first 12 payments of $668.60, based on a 12% interest rate, paid the balance down to $64,764.11 at the end of the first year. The rate goes up to 14% in the second year. But because of the 7½% payment cap, payments are not high enough to cover all the interest. The interest shortage is added to your debt (with interest on it), which produces negative amortization of $471.47 during the second year.

Beginning loan amount = $65,000

Loan amount @ end of first year = $64,764.11

Negative amortization during 2nd year = $471.47

Loan amount @ end of 2nd year = $65,235.58 ($64,764.11 + $471.47)

(If you sold your house at this point, you would owe almost $236 more than the amount you originally borrowed.)

To sum up, the payment cap limits increases in your monthly payment by deferring some of the increase in interest. Eventually, you will have to repay the higher remaining loan balance at the ARM rate then in effect. When this happens, there may be a substantial increase in your monthly payment.

Some mortgages contain a cap on negative amortization. The cap typically limits the total amount you can owe to 125% of the original loan amount. When that point is reached, monthly payments may be set to fully repay the loan over the remaining term, and your payment cap may not apply. You may limit negative amortization by voluntarily increasing your monthly payment.

Be sure to discuss negative amortization with the lender to understand how it will apply to your loan.

Prepayment and Conversion

If you get an ARM and your financial circumstances change, you may decide that you don't want to risk any further changes in the interest rate and payment amount. When you are considering an ARM, ask for information about prepayment and conversion.

Prepayment. Some agreements may require you to pay special fees or penalties if you pay off the ARM early. Many ARMs allow you to pay the loan in full or in part without penalty whenever the rate is adjusted. Prepayment details are sometimes negotiable. If so, you may want to negotiate for no penalty, or for as low a penalty as possible.

Conversion. Your agreement with the lender can have a clause that lets you convert the ARM to a fixed-rate mortgage at designated times. When you convert, the new rate is generally set at the current market rate for fixed-rate mortgages.

The interest rate or up-front fees may be somewhat higher for a convertible ARM. Also, a convertible ARM may require a special fee at the time of conversion.

WHERE TO GET INFORMATION

Before you actually apply for a loan and pay a fee, ask for all information the lender has on the loan you are considering. It is important that you understand index rates, margins, caps, and other ARM features like negative amortization. You can get helpful information from advertisements and disclosures, which are subject to certain federal standards.

Advertising

Your first information about mortgages probably will come from newspaper advertisements placed by builders, real estate brokers, and lenders. While this information can be helpful, keep in mind that the ads are designed to make the mortgage look as attractive as possible. These ads may play up low initial interest rates and monthly payments, without emphasizing that those rates and payments could later increase substantially. Get all the facts.

A federal law, the Truth in Lending Act, requires mortgage advertisers, once they begin advertising specific terms, to give further information on the loan. For example, if they want to show the interest rate or payment amount on the loan, they must also tell you the annual percentage rate (APR) and whether that rate may go up. The annual percentage rate, the cost of your credit as a yearly rate, reflects more than just a low initial rate. It takes into account interest, points paid on the loan, any loan origination fee, and any mortgage insurance premiums you may have to pay.

Ads may play up low initial rates. Get all the facts.

Disclosures From Lenders

Federal law also requires the lender to give you information when you get a mortgage. You should get a written summary of important terms and costs of the loan. Some of these are the finance charge, the annual percentage rate, and the payment terms.

The lender is required to give you specific information about the kind of adjustable-rate mortgage for which you have applied. This information should include the circumstances under which the rate could increase (for example, a rise in the index), what the effects of an increase would be (for example, an increase in your payments or in the length of the loan), and any limitations on the increase (such as any interest rate caps).

Read information from lenders—and ask questions—before committing yourself.

Selecting a mortgage may be the most important financial decision you will make, and you are entitled to all the information you need to make the right decision. Don't hesitate to ask questions about ARM features when you talk to lenders, real estate brokers, sellers, and your attorney, and keep asking until you get clear and complete answers. The checklist at the back of this pamphlet is intended to help you compare terms on different loans.

GLOSSARY

Annual Percentage Rate
A measure of the cost of credit, expressed as a yearly rate. It includes interest as well as other charges. Because all lenders follow the same rules to ensure the accuracy of the annual percentage rate, it provides consumers with a good basis for comparing the cost of loans, including mortgage plans.

ARM (Adjustable-Rate Mortgage)
A mortgage where the interest rate is not fixed, but changes during the life of the loan in line with movements in an index rate. You may also see ARMs referred to as *AMLs (adjustable mortgage loans)* or *VRMs (variable-rate mortgages).*

Assumability
When a home is sold, the seller may be able to transfer the mortgage to the new buyer. This means the mortgage is assumable. Lenders generally require a credit review of the new borrower and may charge a fee for the assumption. Some mortgages contain a *due-on-sale* clause, which means that the mortgage may not be transferable to a new buyer. Instead, the lender may make you pay the entire balance that is due when you sell the home. Assumability can help you attract buyers if you sell your home.

Buydown
With a buydown, the seller pays an amount to the lender so that the lender can give you a lower rate and lower payments, usually for an early period in an ARM mortgage. The seller may increase the sales price to cover the cost of the buydown. Buydowns can occur in all types of mortgages, not just ARMs.

Cap
A limit on how much the interest rate or the monthly payment can change, either at each adjustment or during the life of the mortgage. ARMs may contain one or more types of caps. Payment caps don't limit the amount of interest the lender is earning, so they may cause *negative amortization.*

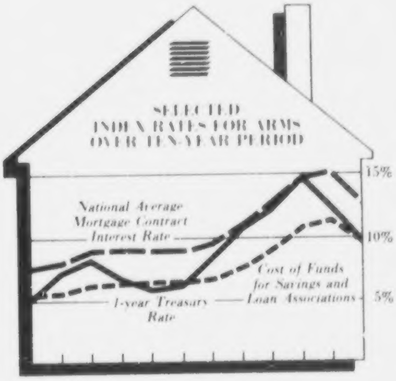
Conversion Clause
A provision in some ARMs that allows you to change the ARM to a fixed-rate loan at some point during the term. Usually conversion is allowed at the end of the first adjustment period. At the time of the conversion, the new fixed rate is generally set at one of the rates then prevailing for fixed-rate mortgages. The conversion feature may be available at extra cost.

Discount

In an ARM with an initial rate discount, the lender gives up a number of percentage points in interest to give you a lower rate and lower payments for part of the mortgage term (usually for one year or less). After the discount period, the ARM rate will probably go up depending on the index rate.

Index

The index is the measure of interest rate changes that the lender uses to decide how much the interest rate on an ARM will change over time. No one can be sure when an index rate will go up or down. To help you get an idea of how to compare different indexes, the following chart shows a few common indexes over a ten-year period (1973-83). As you can see, some index rates tend to be higher than others, and some more volatile. (But if a lender bases interest rate adjustments on the average value of an index over time, your interest rate would not be as volatile.) You should ask your lender how the index for any ARM you are considering has changed in recent years, and where it is reported.



Margin

The number of percentage points the lender adds to the index rate to calculate the ARM interest rate at each adjustment.

Negative Amortization

Amortization means that monthly payments are large enough to pay the interest and reduce the principal on your mortgage. Negative amortization occurs when the monthly payments do not cover all of the interest cost. The interest cost that isn't covered is added to the unpaid principal balance. This means that even after making many payments, you could owe more than you did at the beginning of the loan. Negative amortization can occur when an ARM has a payment cap that results in monthly payments not high enough to cover the interest due.

Points

A point is equal to one percent of the principal amount of your mortgage. For example, if you get a mortgage for $65,000, one point means you pay $650 to the lender. Lenders frequently charge points in both fixed-rate and adjustable-rate mortgages in order to increase the yield on the mortgage and to cover loan closing costs. These points usually are collected at closing and may be paid by the borrower or the home seller, or may be split between them.

MORTGAGE CHECKLIST

Ask your lender to help fill out this checklist.

Mortgage amount

Basic Features for Comparison

Fixed-rate annual percentage rate
(The cost of your credit as a yearly rate which includes both interest and other charges)

ARM annual percentage rate

- Adjustment period
- Index used and current rate
- Margin
- Initial payment without discount
- Initial payment with discount (if any)
- How long will discount last?
- Interest rate caps: periodic
  - overall
- Payment caps
- Negative amortization
- Convertibility or prepayment privilege
- Initial fees and charges

Monthly Payment Amounts

What will my monthly payment be
after twelve months if the index rate—

stays the same?

goes up 2%

goes down 2%

What will my monthly payments be after
three years if the index rate—

stays the same

goes up 2% per year

goes down 2% per year

Take into account any caps on your mortgage and remember it may run 30 years.

Senator GORTON. Thank you. Mr. Dunn.

STATEMENT OF CHRISTOPHER R. DUNN, SENIOR VICE PRESIDENT, BOSTON FIVE CENTS SAVINGS BANK, ON BEHALF OF THE NATIONAL COUNCIL OF SAVINGS INSTITUTIONS

Mr. DUNN. Mr. Chairman, thank you for the opportunity to present the views of the National Council of Savings Institutions on ARM's.

The council has submitted an official statement, which I ask be included in the record.

My name is Chris Dunn. I am a senior vice president and director of lending at the Boston Five Cents Savings Bank. I am a member of the mortgage finance committee of the council.

The council appreciates the fact that these subcommittees are examining ARM's. With the change in monetary policy by the Federal Reserve Board in 1979, the mortgage lending industry has been searching for a loan instrument that will strive in many interest rate environments. This has meant the total relearning of the business by all the participants, and we can see today the fruits of this difficult effort. Mr. Chairman, the primary concern of these subcommittees should be twofold. First, is the current state of ARM money safe for the consumer and what are the benefits for the consumer entering into these transactions?

The second concern should be the retention of the greatest possible latitude on the part of lenders who need great flexibility in structuring their loans in today's mercurial interest rate environment.

Before any decisions are made by the Congress in this area, it is important to note the progress that has been made thus far by the industry and the regulators in addressing the problems that may have existed in the early days of the ARM development.

PROGRESS ACROSS THE BOARD

Indeed, much progress has been made in tightening up the underwriting for the loans, the design of the loans, and the disclosure and information for the consumers. It is the view of the council that the Congress should continue to monitor ARM's, but should not enact any restrictive legislation. We believe that such a restriction would hurt the consumer as well as the housing and lending industries.

To sum up my statement, I would note that the problem of payment shock has been addressed by the PMI's who are unwilling to insure loans with precipitous increases in payments.

Consumer information has been addressed with the promulgation of the consumer booklet on ARM's, with the support of the council. Further actions in the area of truth in lending should improve consumer awareness.

The standardization of a few ARM's is beginning to emerge from the confusing plethora of loans that existed only 2 years ago, further reducing consumer confusion. Greater scrutiny is being paid to appraisals which affect all loans, fixed rate, as well as adjustable, that are made in a noninflationary environment.

The industry has been addressing concerns about ARM's raised in the past few years. The ARM has moved well to help address the affordability problem, at times when the fixed rate loan has risen above rates acceptable to the majority of consumers.

We would urge that you not enact legislation restricting ARM's and thereby cut off this critically important mortgage option.

In closing, I must applaud the subcommittees for examining the issues of adjustable rate mortgages. There have unquestionably been some cases of poor loans in the market, but they are the exception and not the rule. We share the subcommittees' concerns over the status of ARM's and appreciate the opportunity to appear today.

I will be very happy to answer any questions.

[The complete prepared statement follows:]

STATEMENT OF

CHRISTOPHER R. DUNN

ON BEHALF OF

THE NATIONAL COUNCIL OF SAVINGS INSTITUTIONS

Mr. Chairman, thank you for the opportunity to appear today to present the views of the National Council of Savings Institutions on the subject of adjustable rate mortgages. My name is Christopher R. Dunn and I am Senior Vice President and Director of the Lending Division at the Boston Five Cents Savings Bank, and I am a member of the Council's Mortgage Finance Committee.

As you may know, the National Council of Savings Institutions was formed a year and a half ago with the consolidation of the National Association of Mutual Savings Banks and the National Savings and Loan League. The Council represents approximately 600 savings institutions with $400 billion in assets.

The Council appreciates the fact that these Subcommittees are examining adjustable rate mortgages (ARMs). With the deregulation of interest rates by the Federal Reserve Board in 1979, the mortgage lending industry has been searching for a loan instrument that will thrive in any interest rate environment. This has meant a total re-learning of the business by all the participants, and we can see the fruits of this difficult effort.

Mr. Chairman, the primary concern of these Subcommittees should be twofold. First, is the current state of ARM lending safe for the consumer and what are the benefits for the consumer entering into these transactions. The second concern should be the retention of the greatest possible latitude on the part of lenders who need great flexibility in structuring loans in today's mercurial interest rate environment. Before any decisions are made by the Congress in this area, it is helpful to note the progress that has been made thus far by the industry and the regulators in addressing problems that may have existed during the early phases of the ARMs development.

Indeed much progress has been made in tightening up the underwriting for the loans, the design of the loans, and the disclosure and information for the consumers. It is the view of the Council that the Congress should continue to monitor ARMs, but should not enact any restrictive legislation. We believe that such a restriction would hurt the consumer as well as the housing and lending trade industries.

Lower Inflation Changes Mortgage Dynamics

These Subcommittees should consider the fact that the mortgage business is in the process of weathering a major change, and that is the disappearance of steady and significant levels of inflation in home prices. While we all applaud the reduction in inflation, it has changed the dynamics of mortgage lending.

For the past decade, the appreciation in homes has led consumers to view their home purchases as the single most lucrative investment possible. Consider that with a 10 percent increase in price annually, a home buyer putting 5 percent down for a 95 percent loan would realize a 200 percent return on investments in one year. Homes became viewed as investments and not shelter. The corollary to the American Dream of home ownership has been the road to equity through inflation.

While being lamented by almost every citizen, this pernicious inflation had some hidden benefits for those in mortgage finance. First, as mentioned earlier, the appreciation in home prices created a large demand for mortgage credit other than to provide shelter. Inflation also covered over many of the blemishes that may have existed in loan underwriting, including appraisals and credit reviews. If the assessed value of the property was, shall we say, optimistic, and a 95 percent loan-to-value ratio was in fact a 101 percent loan-to-value ratio, inflation quickly provided the owner with equity in the property and the lender or investor with a safer instrument.

Inflation-wrought equity provided the home owner with incentives to hold onto the home no matter what the financial sacrifice. Indeed, the standard qualifying income/debt support ratios rose, allowing mortgage payments to consume increasingly larger amounts of a mortgagor's income. No matter--inflation made the consumer's gain worth the pain.

The mortgage industry must now operate in a non-inflationary environment. In fact, the recent survey of existing home sales by the National Association of Realtors indicates that some of yesterday's hottest markets are facing declining values. Conversely, some of the poorest markets in the past are showing the greatest appreciation in values (see Exhibit A). What this means is that lenders' loan underwriting will have to take into account the local market factors to determine the ultimate soundness of a loan and future problems it might cause.

With little or no inflation, some consumers are showing less desire to hold onto burdensome mortgages on properties not appreciating in a manner to which they have become accustomed. Inflation does not retroactively mollify an appraisal that does not, for instance, take into account concessions in the financing package. Furthermore, the high loan-to-value ratios that have been commonplace in the recent past may be harder to find or more expensive for the consumers as investors and mortgage insurers view them as bearing special risks.

ARMs

In 1981, the thrift industry was suffering from disintermediation wrought by the inability of depository institutions to compete with money market mutual funds that could offer savers market rates of return on their savings. Now, with the Garn-St Germain Act of 1982 completing the process started with the Depository Institutions Deregulation and Monetary Control Act of 1980, thrifts have deregulated liabilities.

The need for thrifts to have mortgage assets in their portfolio that will adjust with fluctuations in interest rates is essential if they are to remain viable and strong supporters of housing. Since thrift institutions are the largest investors of mortgages, to restrict our ability to garner adjustable mortgage assets would pose serious problems for the future viability of the thrift industry to support housing. We simply cannot put the genie back in the bottle and recreate the highly regulated interest rate environment that worked in the past. Most funds of thrifts are of maturities of six months or less. Until someone can guarantee stable long-term rates, thrifts will have to price mortgages on the short-term market. Adjustable rate mortgages enable thrifts to do this and will continue to be a big part of the future. Our customers and your constituents would no doubt prefer the fixed rate, low interest mortgage that served our needs so well in the past, but that is something that is not within the realm of reality as prescribed by today's volatile interest rate environment.

In 1981, ARMs were essentially an academic issue. By and large, consumers were not willing to accept these loans, and the lending community had not learned how to develop ARMs acceptable to consumers. However, lenders experimented with a variety of loans and we are seeing a standard product beginning to emerge.

As with all educational experiences, some mistakes were made. Some of the loans offered may turn out to pose serious problems for the borrowers due to poor design or inadequate disclosure. Others may turn out to be poor assets for thrifts who may have conceded too much to the borrower.

In 1983 and 1984, the market developed ARMs at an astonishingly fast pace. Hundreds of different types of loans were devised and tested in this market. One basic measure of success has been the acceptance by the consumer, and many loans have failed to meet this test. However, other loans have met the needs of consumers quite nicely.

We are seeing some standardization of ARMs beginning to emerge. That is, many of the ARMs today offer many of the same features and options, so that the lists of products that ranged in the hundreds now are far fewer in number.

National Council ARM Survey

As part of a continuing effort to gather data on the impact of ARMs of the housing finance market, the Council conducted a survey of the membership in June 1984 and also in December 1984 to determine their use of adjustable rate mortgages in the first and second half of 1984. We are including the results of these surveys as Exhibit B and Exhibit C respectively, and we ask that they be made part of the hearing record.

Of total mortgage originations during the second half of 1984, 73 percent were in the form of ARMs, while 22 percent were in the form of fixed-rate instruments. These results mirror national trends--the Federal Home Loan Bank Board reported that ARMs accounted for 70-75 percent of thrift originations during the second half of 1984, a slightly lower figure than during the first half of 1984.

A typical ARM offered by Council members was indexed to either the internal cost of funds to the institution or to one-year Treasury bill notes. For the most part, institutions relied on a single ARM per institution, with the most popular instrument accounting for 86 percent of originations. Thus, it appears that the early period of ARM experimentation has settled into the pattern of a single option per institution for the borrower seeking an ARM.

The majority of ARMs used by Council members carried interest rate caps. Interest rate caps averaging 2 percent per year and 6 percent over the life of the loan were used in over four-fifths of originations. In comparison with the Council's June 1984 survey, the percentage of ARMs with interest rate caps increased by approximately 20 percent.

The December 1984 survey also revealed that the majority of institutions qualify ARM borrowers at the initial interest rate. The next most frequent qualifying measure was the maximum rate after one year--typically the initial rate plus two points. These results remain virtually unaltered from the previous survey.

The pattern of secondary market activity that we noticed in the past two surveys has continued in that the majority of fixed rate originations by Council members are being sold, while most ARMs are being kept in portfolio. For the second half of 1984, 77 percent of all fixed rate originations were sold in the secondary market, while only 40 percent of ARMs were sold.

Resolution of Potential Problems

The choice of a variety of instruments is important to both lenders and borrowers. Many borrowers have different needs that can be determined by income, job mobility, and prospects for future income, to name but a few. It will help these consumers to have a range of choices to make as they approach their mortgage decision. We are no longer in an environment in which one loan instrument can serve the market's needs.

While we are excited about the future of ARMs, and what it means to thrifts, the housing industry, and the home buying public, we must acknowledge that we share your concerns about potential problems. Let me outline briefly these possible pitfalls.

Payment Shock

With an adjustable rate mortgage, one that truly reflects changes in interest rates, the danger is that the borrower will be confronted with increases in mortgage payments that he or she cannot meet. Payment shock can also be a problem when a mortgage starts at a significant discount from the rate established by the index used and the margin over that index. You can find in some of these situations that a borrower's payment will increase even if interest rates in general do not. This problem has been addressed by the mortgage insurance industry's reluctance to insure loans with more than 15 percent annual payment increases. Payment shock has been addressed at length by private mortgage insurers, one element of the industry that stands to lose if consumers cannot maintain their loans. This industry insures investors against losses if mortgages fail, and increases the marketability of the loan in the secondary market in the future, should the lender choose that option.

Private mortgage insurers have worked to tighten up the requirements on loans they will underwrite in order to minimize the risk of borrower default. MGIC, to name one, revised its standards to limit the initial year discounted rate to 3 percent below the mortgage rate or fully indexed accrual rate for ARMs. This means if a mortgage is priced at 2 1/2 points over the one-year Treasury index, which is currently 9.54 percent, the first year rate charged to the borrower could not be below 9.04 percent, or 3 percent below the actual rate of 12.04 percent.

MGIC has also limited the amount of negative amortization that they will accept in an ARM to 125 percent of the original loan balance. This figure is generally accepted as the safe limit for all parties concerned.

Payment shock concerns the portfolio lender as well. Problem loans mean that the lender is often going to lose money. First, as the loan becomes delinquent, there are charges incurred in the servicing of the mortgage that must be assumed by the lender. Should problems continue, the portfolio lender must foreclose, losing both principal and interest. Lenders do not gain from foreclosures for the additional reason that properties they come to own are generally the poorer ones. The better properties have been sold by the borrower to extinguish their debt. If a loan program is not beneficial for the consumer, it will cause problems for the lender as well. Both lender and borrower are in the loan transaction together.

We are beginning to see payment or interest rate increase caps become commonplace as borrowers have insisted that the risk they assume be limited. It is common to see a one or two percent interest annual rate increase and a 5 percent cap over the life of the loan. As I mentioned, it is also common to find annual increase caps based on actual payments, and 7 1/2 percent is the most common of these.

Equity Shock

With lower inflation and some loans that offer discounted rates, it is possible that borrowers will see no increase in equity and may see erosion of equity. One way to address this is to limit negative amortization in a loan, but the underlying assumption of the property's value--the appraisal--cannot be overlooked. It is critically important that any appraisal made today accurately reflects the value of financing in assessing the real sales price of a home.

Outdated Disclosure

The truth-in-lending requirements of disclosure for the borrower must also be changed to reflect the new facets of adjustable rate loans. Simply telling the borrower what the APR is for the first year of a loan will not help that borrower assess the real risk of that loan, and therefore its desirability. Lenders should disclose what the borrower can expect under many circumstances--including the maximum rate after one year, and over the life of the loan, which is known as worst-case disclosure.

The consumer must be assisted to become an informed player in the capital markets; to assess risk and other terms in mortgages and arive at an acceptable cost associated with that risk.

The National Council worked in conjunction with the Federal Reserve and several housing groups to develop the "Consumer Handbook on Adjustable Rate Mortgages", which was prepared in response to a request from the House

Committee on Banking, Finance and Urban Affairs. We feel that this is an excellent and informative guide for the consumer, and we have encouraged distribution of the handbook among our member institutions to their customers.

Last month the Federal Financial Institutions Examination Council (FFIEC) submitted a general outline of a plan to the Federal Reserve Board which recommends ARM disclosures by lenders before an application has been received; a disclosure that explains the adjustable rate mortgage and possible hazards; and a worst-case scenario which describes how an ARM would vary in an environment where rates increase two percentage points each year over a three-year period.

The Fed is also publishing in final form changes to the official staff commentary to Regulation Z with a uniform effective date of October 1, 1985. Changes involving discounted ARMs include disclosure of the composite annual percentage rate based on the initial rate for as long as it is charged and, for the remainder of the term, the rate that would have been applied using the index or formula at the time of origination. The rate at origination does not need to be used if a contract provides for a delay in the implementation of changes in an index value. The effect of the multiple rates must also be reflected in the calculation and disclosure of the finance charge, total of payments, and payment schedule. The effect of a rate or payment cap on a discounted ARM that would prevent the initial rate or payment--at the time of the first adjustment--from changing to the rate determined by the index or formula at the origination, should also be part of the disclosures.

Disclosure and greater understanding by everyone involved with ARMs will also be greatly assisted by the recent development of standardized ARM documents that have been developed by Fannie Mae and Freddie Mac. This development will reduce much of the current confusion that has resulted from a myriad of forms as well as different loans themselves.

It is reasonable to conclude that in a year's time, the standardization process will continue, and more uniform and complete consumer safeguards will help the understandably bewildered consumer make intelligent decisions.

The Secondary Market for ARMs

The progress towards standardization is also evidenced by the imminent securitization of ARMs. Several of the large investment banking firms and other national mortgage market players have been working hard to develop ARM morgage-backed securities. Since securities require a large volume of a uniform product for collateral, the growth of these mortgage-related investment vehicles will increase standardization in the market. Furthermore, investors in MBSs will have to be assured that the loans will be stable, and therefore relatively safe for the borrower, in order to ensure the success of the securities and investor acceptance.

This process may be aided by the young GNMA ARM program. Many in the market are interested in the success of that program, and its results will provide useful information in further developing the conventional ARM mortgage-backed security. Unfortunately, the lack of activity in this program to date may indicate that the restricted nature of the FHA ARM (limited to a 1 percent increase per year) will diminish its effectiveness.

The federal secondary market agencies, FNMA and FHLMC, have also taken important steps that will address the concerns of the Subcommittee. After an initial period of buying a wide variety of ARMs, Fannie Mae, the largest agency purchaser of ARMs, limited the number of loans it will purchase, and has significantly tightened up its policies. Fannie Mae has now stated it will not purchase loans with an initial interest rate more than 2 1/2 percent below the fully indexed accrual rate. Fannie Mae offers important consumer-oriented options such as annual and life-of-loan interest rate caps.

Freddie Mac has also taken on the role of industry watchdog in its development of criteria for assessing loans insured by PMIs. These underwriting guidelines set limits on payment increases, negative amortization, and borrower qualification on all loans receiving private insurance, whether or not that loan is purchased by Freddie Mac.

In closing, I must applaud these Subcommittees for examining the issue of adjustable rate mortgages. There have unquestionably been some cases of poor loans in the market, but they are the exception, not the rule.

We share the Subcommittees' concerns over the status of ARMs, and appreciate the opportunity to appear today. I would be happy to answer any questions you may have at this time.

EXHIBIT A

MEDIAN SALES PRICE OF EXISTING SINGLE-FAMILY HOMES FOR METROPOLITAN AREAS
(In Thousands of Dollars)

	YEARS		Percent change	QUARTERS					Percent change
	1983	1984	1983 1984	1983	1984				1983:IV 1984:IV
				IV	I	II	III	IV p	
Albany	$49.4	$52.7	6.7%	$51.0	$52.0	$53.4	$52.4	52.7	3.3%
Anaheim/Santa Ana*	134.9	133.7	-0.9	133.7	133.5	135.1	134.9	130.6	-2.3
Atlanta	63.0	66.2	5.1	65.8	67.9	63.9	64.6	68.5	4.1
Baltimore	n/a	66.2	n/a	n/a	64.2	67.7	65.2	67.8	n/a
Birmingham	62.8	65.1	3.7	61.4	65.0	65.7	66.6	61.7	0.5
Boston	82.6	100.0	21.1	84.9	89.4	95.6	102.0	104.8	23.4
Chicago	76.4	79.5	4.1	75.9	77.8	80.3	77.5	77.8	2.5
Cincinnati	57.2	58.9	3.0	56.0	58.7	59.7	59.6	57.2	2.1
Cleveland	n/a	62.7	n/a	61.7	59.8	62.9	65.4	61.4	0.5
Columbus	59.4	59.9	0.8	58.8	60.2	61.1	60.4	57.4	-2.4
Dallas/Ft. Worth	76.0	82.4	8.4	77.1	81.0	84.3	83.4	81.7	6.0
Denver	78.3	82.7	5.6	78.2	79.6	82.4	85.0	82.7	5.8
Detroit	47.5	48.5	2.1	47.8	48.1	49.6	48.0	47.9	0.2
Ft. Lauderdale	73.9	73.1	-1.1	72.3	69.9	71.4	76.0	73.5	1.7
Houston	79.9	77.6	-2.9	80.0	78.4	77.6	79.6	74.8	-6.5
Indianapolis	52.8	53.1	0.6	49.8	50.6	55.5	54.2	51.5	3.4
Kansas City	58.8	59.2	0.7	56.4	60.8	59.6	57.6	59.5	5.5
Los Angeles*	112.7	115.3	2.3	111.5	114.2	117.0	115.3	114.5	2.7
Louisville	47.4	48.9	3.2	46.5	47.9	49.3	49.5	48.3	3.9
Memphis	61.6	64.1	4.1	61.8	62.0	64.4	65.2	64.5	4.4
Miami	n/a	80.2	n/a	75.9	79.8	78.7	82.1	80.4	5.9
Milwaukee	68.0	68.2	0.3	66.7	69.8	68.1	69.6	64.1	-3.9
Minneapolis/St. Paul	73.6	74.0	0.5	73.7	73.4	73.8	75.1	73.6	-0.1
Nashville	61.0	62.9	3.1	61.0	60.0	63.9	64.0	62.8	3.0
New York Metro Area**	88.9	105.3	18.4	94.4	100.6	105.4	106.9	107.8	14.2
Oklahoma City	61.6	63.9	3.7	62.9	62.1	65.4	63.6	64.4	2.4
Philadelphia	59.6	60.3	1.2	58.6	59.8	62.0	59.8	59.5	1.5
Providence	54.7	59.6	9.0	56.2	56.5	60.8	61.4	59.3	5.5
Rochester	54.8	59.7	8.9	54.9	55.4	60.3	62.1	60.4	10.0
St. Louis	58.9	61.8	4.9	58.7	57.5	62.4	64.4	61.9	5.5
Salt Lake City	64.3	65.8	2.3	63.1	64.0	65.1	67.1	66.7	5.7
San Antonio	62.6	68.0	8.6	62.3	64.5	68.7	71.6	63.9	2.6
San Diego*	98.9	100.2	1.3	98.6	96.3	98.9	102.9	104.9	6.4
San Francisco*	129.5	129.9	0.3	129.4	126.6	130.5	132.6	130.4	0.8
San Jose	127.6	123.1	-3.5	128.6	125.0	124.0	121.6	119.0	-7.5
Tampa	55.5	58.2	4.9	55.4	55.6	58.2	60.8	57.7	4.2
Washington, D.C.	89.4	93.0	4.0	89.0	91.3	95.5	92.9	91.7	3.0

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n/a Not Available.

p Preliminary

* Provided by the California Association of REALTORS®

** Including Long Island and Newark

Source: NATIONAL ASSOCIATION OF REALTORS®, Economics and Research Division

EXHIBIT B

NATIONAL COUNCIL OF SAVINGS INSTITUTIONS

Semiannual ARM Survey

At the end of June, the Council's Research Department surveyed the membership to determine their use of adjustable rate mortgages in the first half of 1984. Of the Council's 582 members, 369 responses were received. Ninety percent of those responded offered ARMs during the period of the survey. The survey was the second in a series conducted by the Council and aimed at measuring the activity of thrift institutions in the mortgage market. The first of these surveys was taken in December 1983 and covered the entire year. However, due to differences in information requested, the results of the two surveys are not comparable.

Of the respondents to the survey, 90 percent offered adjustable mortgages during the first half of 1984. The most frequently used ARM accounted for 83 percent of the mortgage originations at these institutions. For these instruments, the most frequently used indexes were the one-year Treasury bill rate and the Federal Home Loan Bank Board ARM Index. Together, these accounted for half of all adjustable loans made. A significant number of loans were tied to an average of Treasury security rates and a surprisingly high 17 percent were linked to an internal cost of funds index for the individual institution. For the most part, Council members used a two-point spread over these indices and then discounted the loans an average of three points over the market determined rate. Thus, the typical ARM originated by a National Council member carried an initial interest rate one point below the market value of the chosen index. When one-year Treasury bills were yielding 12 percent, for example, loans tied to this index carried an initial rate of 11 percent. Charts 1 through 3 show the breakdown of indices, spreads and discounts used by National Council members.

A little over half of all the ARMs originated by Council members are adjusted on an annual basis, while a little over one-quarter are adjusted on a three-year cycle. Relatively few are adjusted on a monthly basis (4.24 percent). This pattern reflects the geographic distribution of responses. By and large, monthly adjustables are more prevalent in California and the West, while longer adjustment periods characterize mortgages originated in other parts of the country, particularly the Northeast. The coverage of the survey emphasizes those areas where longer periods are more common with less than proportional representation from California. Chart 4 shows the breakdown of adjustment periods for our respondents.

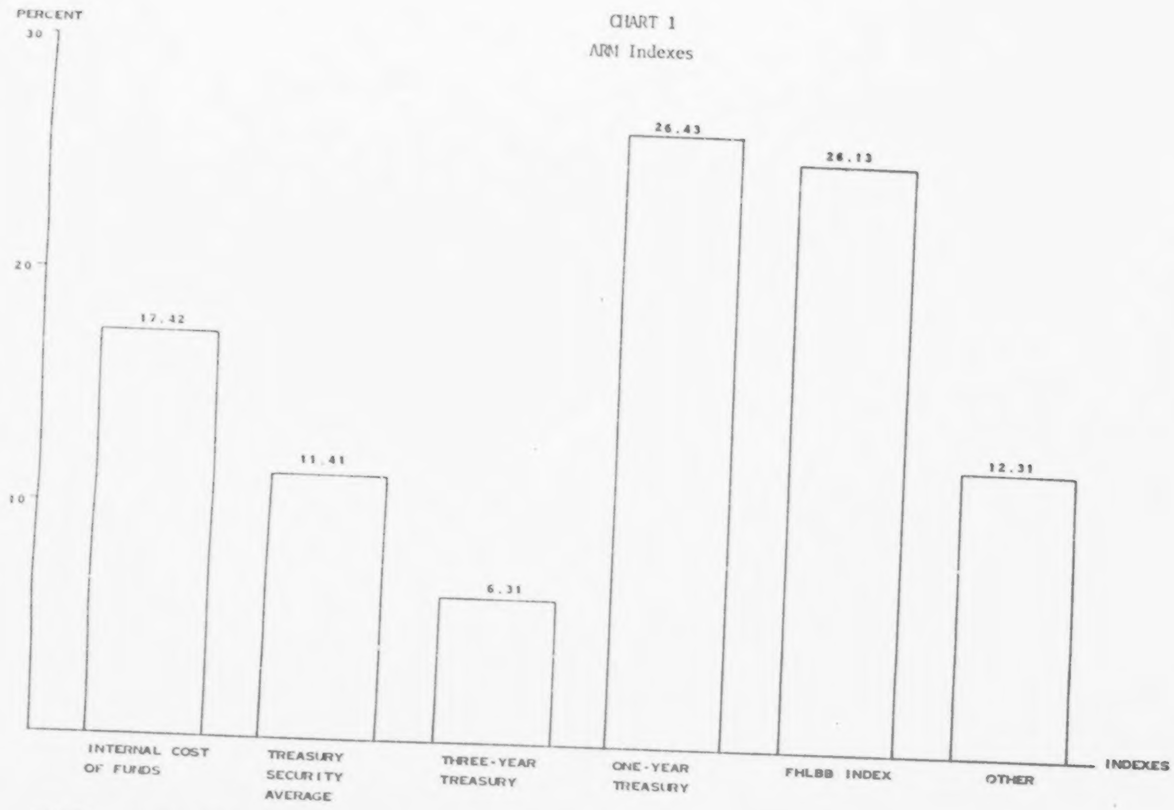
For the most frequently used ARMs, nearly two-thirds carried interest rate caps. In comparison with our first survey, there has been an increase in the use of interest rate caps. It appears that the market is forcing the use of caps, rendering the intended actions of the Congress unnecessary. The average rate cap used by Council members was 2 percent per year and 5 percentage points over the life of the loan. In 56 percent of the cases, interest rate decreases were also capped; in nearly 62 percent of all cases, the interest rate cap applied to the first payment. Chart 5 gives the range of interest rate caps applicable to ARMs originated by National Council members.

Payment caps, on the other hand, were less popular. Only 12.5 percent of the most frequently used ARMs carried payment caps, typically 4 percent per year and 9 percent over the life of the loan. Most institutions, however, did offer payment caps on their second most frequently used ARM. The pattern we see here is an institution doing its major ARM business through a rate-capped instrument while offering a payment-capped alternative. For the most frequently used ARM, 64.3 percent carried either rate or payment caps.

Most institutions (69.78 percent) qualified borrowers at the initial ARM rate, while an additional 14 percent used the maximum rate after one year (typically the initial rate plus two points).

Secondary market activity in both ARMs and fixed-rate mortgages was relatively strong. Of the fixed-rate instruments originated by National Council members in the first half of 1984, 74 percent were sold in the secondary market. For ARMs, 14 percent were sold. These results are somewhat surprising, as they indicate rather more fixed-rate investment and adjustment rate sales than we would have expected.

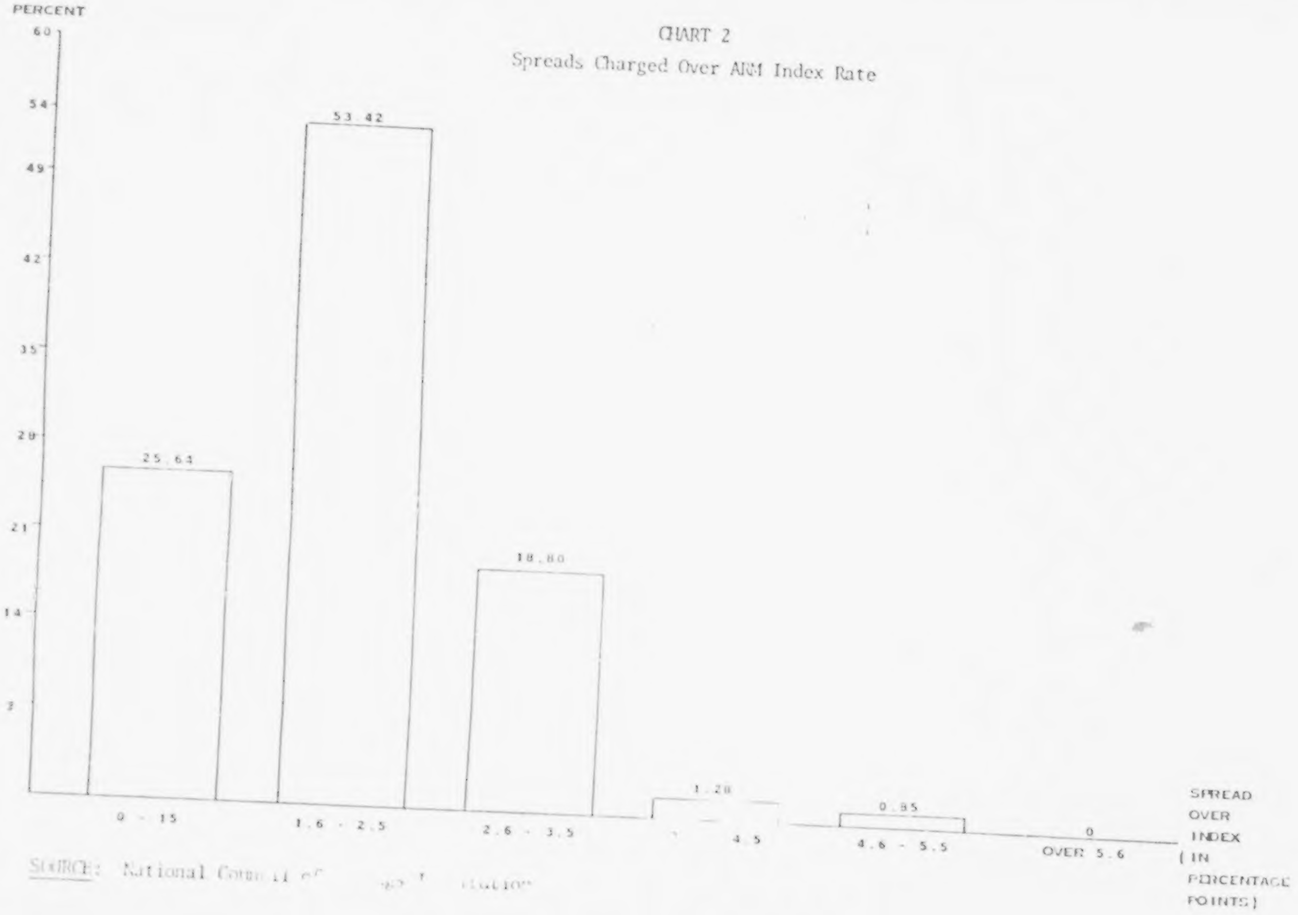
CHART 1
ARM Indexes



SOURCE: National Council of Savings Institutions

CHART 2

Spreads Charged Over ARM Index Rate



SOURCE: National Council of [illegible]

CHART 3

Discounts Applied to Initial ARM Rate

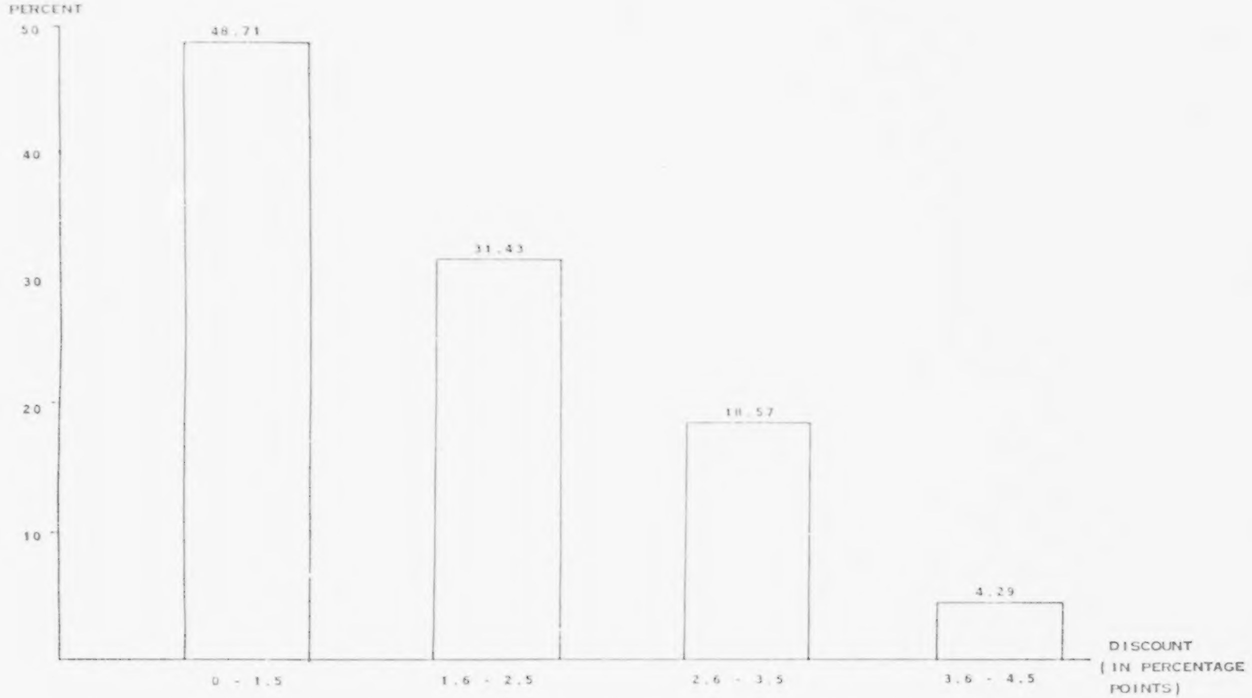
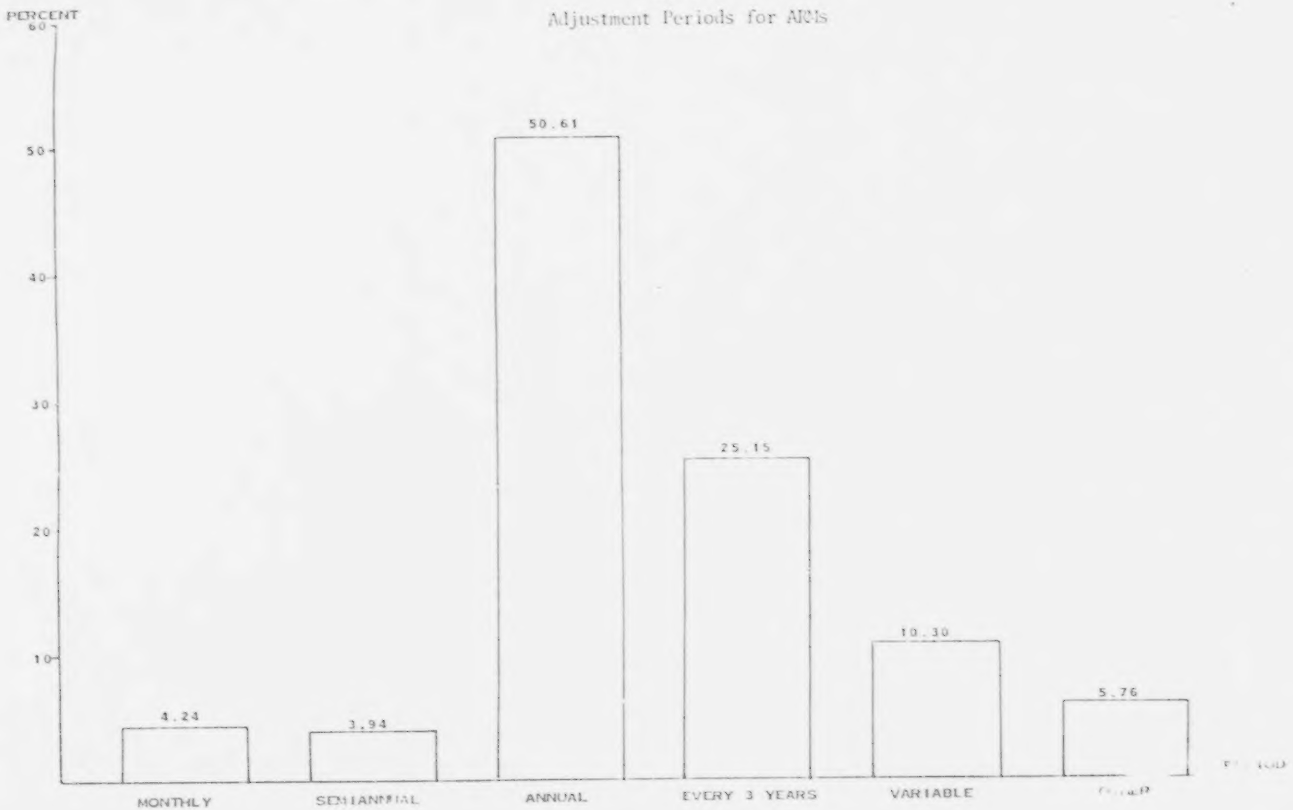


CHART 4

Adjustment Periods for ARMs



SOURCE: National Council of Savings Institutions

CHART 5

ARM Interest Rate Caps

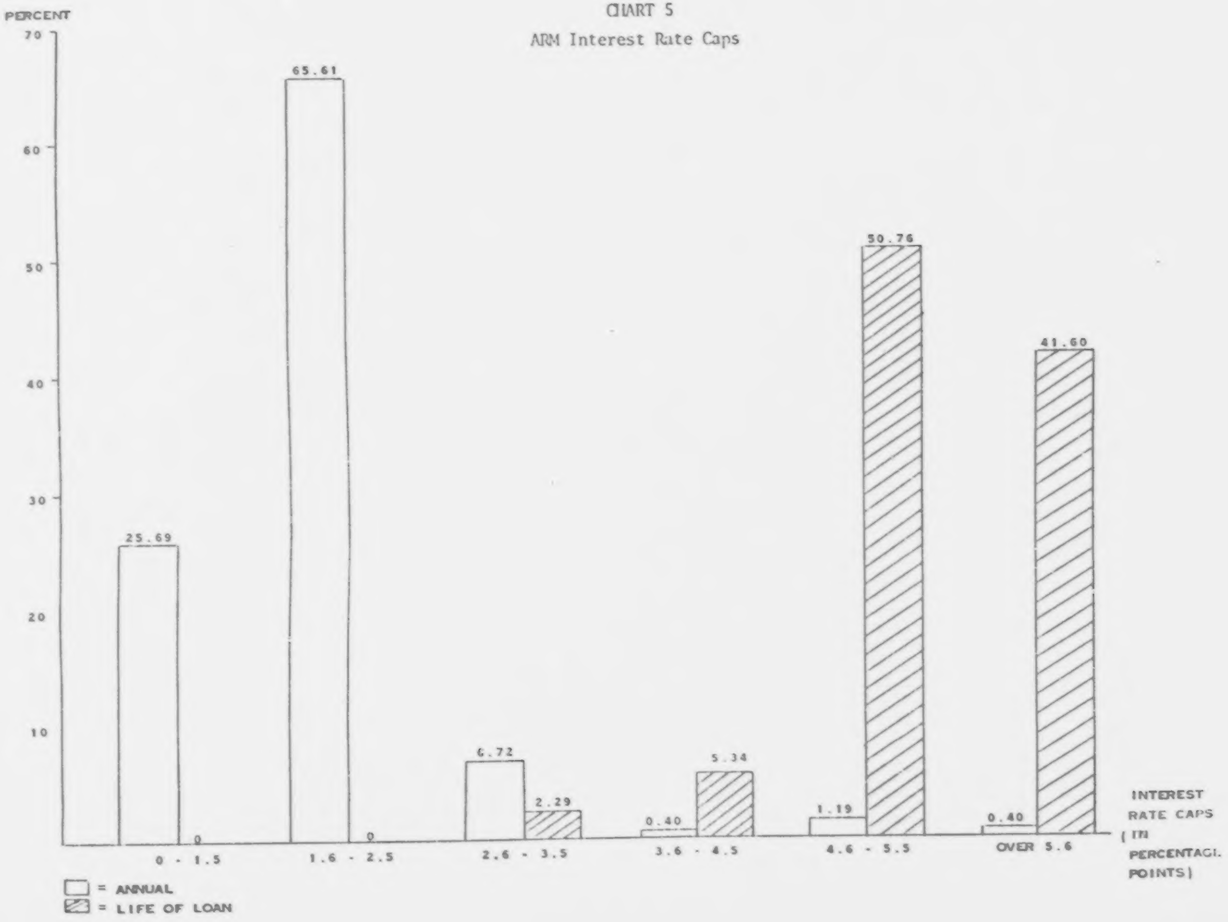


EXHIBIT C

SEMIANNUAL SURVEY OF ADJUSTABLE RATE MORTGAGES

At the end of December, the National Council's Research Department surveyed the membership of the Council to determine their use of adjustable rate mortgages in the second half of 1984. This is part of a continuing effort to gather data on the impact of ARMs on the housing finance market. The survey received 281 responses. Ninety-four percent of those responding offered ARMs during the period. Of total originations, 73 percent were in the form of ARMs, while 22 percent were in the form of fixed rate instruments. These figures mirror national trends: the Federal Home Loan Bank Board reported that ARMs accounted for 70-75 percent of thrift originations during the second half of 1984.

The typical ARM was indexed to either the internal cost of funds to the institution or to the one-year Treasury bill rate. Together these two indices accounted for over half of all ARM originations. The pattern differed slightly between savings banks and savings and loans with the banks more prone to use the Treasury bill rate and the savings and loans relying more heavily on the FHLBB ARM Index. Problems with this index, however, limited its use by both types of institutions, and the Treasury bill rate was more popular, even among savings and loans. For the most part, institutions relied on a single ARM, with the most popular instrument accounting for 86 percent of originations. Thus, it appears that the early period of ARM experimentation has settled into the pattern of a single option for the borrower seeking an ARM. This most popular instrument, however, differed from institution to institution, so that there was variety among sources of funds, if not in a single institution.

For the most part, ARMs used by Council members carried interest rate caps. In over four-fifths of originations, interest rate caps, averaging 2 percent per year and 6 percent over the life of the loan, were used. In 70 percent of the cases, the cap applied at the first payment adjustment and decreases in rates, as well as increases, were capped. Conversely, payment increases were not generally capped on the main ARM instruments used by respondents. If an institution offered more than one ARM option, the second instrument would usually be payment capped. But, in the main, interest rate caps were far more frequent. Since the June 1984 survey, the percentage of ARMs with interest rate caps increased substantially, to 82 percent.

The survey also revealed that the vast majority of institutions qualify ARM borrowers at the initial interest rate. Two-thirds of all originations used this rate, which on average was equal to the index rate at the time of origination. The next most frequent qualifying measure was the maximmum rate after one year, and this covered only 16 percent of ARM originations.

The pattern of secondary market activity that we noticed in the past two surveys has continued in that the majority of fixed rate originations by Council members are being sold, while most ARMs are being kept in portfolio. For the second half of 1984, 77 percent of all fixed rate originations were sold in the secondary market, while only 40 percent of ARMs were sold.

Highlights of ARM Activity,
June-December 1984
(percentages unless otherwise noted)

	Total	Savings Banks	Savings and Loans
Offering ARMs	94.3	94.2	95.1
Originations			
ARMs	73	74	63
Fixed rate	22	21	27
Sold in Secondary Market			
ARMs	40	42	38
Fixed rate	77	79	69
ARM Index			
Cost of funds	22.9	25.6	7.3
One year Treasury	31.2	29.1	43.6
FHLBB index	18.8	17.5	25.6
ARMs with Interest Caps	82.2	82.1	82.4
Average Cap			
One year	2.0	2.0	2.0
Life of loan	6.0	6.0	6.0
Qualification of Borrower			
Initial rate	66.9	66.7	68.3
Maximum one year rate	16.4	16.3	17.1

* * * * * * * * * * *

EXHIBIT D

Highlights of ARM Activity
1984
(percentages unless otherwise noted)

	June 1984	December 1984
Originations[1]		
ARMs	83	73
Fixed rate	17	22
Sold in Secondary Market[2]		
ARMs	44	40
Fixed rate	74	77
ARMs with Interest Caps[3]	64.3	82

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[1] 10 percent decrease in ARM originations during second half of 1984

[2] Majority of fixed rate originations are being sold; majority of ARMs kept in portfolio.

[3] 17.7 percent increase in interest rate capped ARMs

Senator GORTON. Thank you, Mr. Dunn.

Before we go on to you, Mr. Colton, Senator D'Amato is here, and I believe he has a statement.

Senator D'AMATO. Mr. Chairman, first of all, let me commend you for holding these hearings. I think it will prove valuable and important. The adjustable rate mortgages have developed to meet the interest-sensitive assets and the balance of regulated interest with liabilities. There are cases where there have been abuses, and I share overall a feeling that what we want to do is deal with the abuses without destroying the program.

Some have called for outright limitations or bans. I don't believe that that would be the wisest thing, but Mr. Chairman, be that as it may, I would like permission to place a statement in the record, as if read in its entirety.

Senator GORTON. Without objection.

STATEMENT BY SENATOR D'AMATO

Senator D'AMATO. The adjustable rate mortgages were developed because mortgage lenders needed interest-sensitive assets to balance deregulated interest sensitive liabilities.

Many home buyers did not like ARM's, they were leary of adjustments and their ability to make higher payments. However, they are now more popular with the consumer. There are a variety of reasons for this popularity, including the fact that the spread between ARM's and standard fixed-rate loans widened, making the relative cost of an ARM less expensive.

Although, there is reason to be concerned about the practices of a few unscrupulous lenders who take advantage of uninformed buyers, this is no reason to overreact. We should thoroughly examine the abuses and find out what the industry is doing to eliminate further abuse. Consumers should not lose out because of the practices of a few lenders.

I commend Chairmen Hecht and Gorton for calling this hearing and for bringing this important issue to light.

And then I would like to further commend you, by way of these hearings, if we can focus in on these issues, we can come up with the kind of initiatives that will not knock out the program in its entirety and yet will deal with the abuses.

Senator GORTON. Thank you, Senator. Mr. Colton.

STATEMENT OF KENT COLTON, EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. COLTON. Thank you, Mr. Chairman, Senator D'Amato.

I am pleased to be here as the executive vice president of the National Association of Home Builders, which represents over 131,000 members of the homebuilding industry.

As you requested, I will submit my written statement for the record and only highlight a few items this morning.

As you know, Mr. Chairman, the Nation's housing finance system is evolving rapidly, driven by deregulation, innovations in financial markets and technological changes, and the mortgage delivery system.

NAHB recently completed a year-long study entitled "Housing in America: The Challenge Ahead." I hope all the members of this committee have had a chance to see it and perhaps look through it, but what it notes in the housing finance area is that the primary basic issues have shifted over the last two decades, whereas in the decade of the 1970's, the major question was the availability of funds.

Mortgage markets are now generally more efficient. The real issue in the 1980's is no longer the availability of mortgage credit; it is rather, interest rates and the affordability of mortgage credit.

In this new enviroment, adjustable rate mortgages have already shown that they provide an important alternative in the market. They contribute to housing affordability. They assist thrift institutions in matching their assets and liabilities, as we have already heard, and they help alleviate the impact on high-interest rates on the housing cycle.

THREE MAJOR ISSUES OF CONCERN

However, Mr. Chairman, despite the many benefits of ARM's, we also recognize at NAHB, that they are not without concern. Our testimony identifies at least three major issues or questions that the Congress should be aware of.

The first relates to whether or not the market is regulating itself.

The second relates to the consumer and whether he or she understands this product.

The third relates to the credit risks involved that are associated with ARM's.

Time does not permit a full discussion of all three of these, so I will simply make two major points in summary. First, we believe that although there have been some abuses, the market has worked remarkably well in the past several years, and congressional action at the present time to impose particular design standards or consumer safeguards would be a mistake.

The charts and analysis in our testimony substantiate this point. For example, chart 1 shows that the consumer still has a choice with respect to ARM's, and in fact, that a majority of households probably still prefer the fixed rate mortgage, if they can address the affordability question. Back in August, ARM's were 68 percent of the market. In February, they were 46 percent of the market, because interest rates dropped. Chart 3 shows that the market has also recognized that consumer preferences with respect to caps are important and the market is clearly moving toward standardized caps.

In fact, Mr. Chairman, in order to allow FHA to keep pace with this market, we urge the committee and Congress to support changes in the FHA ARM Program that will increase market acceptability. Specifically, we would recommend that the annual interest rate cap of 1 percent be removed and be allowed to rise to a 2-percent cap.

The second thing I want to address is one that I understand came up in the first panel, that relates to the question of credit quality, and more specifically, to buydowns and appraisals.

As I mentioned at the outset, the primary issue in housing finance today is not the availablility of mortgage credit, but the affordability of mortgages. When rates were particularly high in the early 1980's, various actors in the market responded by trying to buy the rates down for the consumer, in order to get monthly payments down to an affordable level. Builders brought rates down for new homes. Lenders did it for adjustable rate mortgages, in order to encourage their use, and sellers did it in order to sell their homes; however, almost 1 year ago, NAHB became concerned that the potential existed for abuse with respect to this practice.

At our 1,600-person board of directors meeting held in May 1984, we passed a resolution recognizing the importance of reasonable buydowns, but also calling for the end to extreme payment and interest rate increases.

However, let me make it clear. Abusers are the exception, not the rule.

APPRAISAL PRACTICES

In recent months there have been some discussions concerning the effect of such abuses on the price or value of the home. Some have suggested changing the appraiser from the current market value to liquidation value. Others have raised the concept of cash equivalency which would try to discount all the special financing from the value of the home.

NAHB would oppose such changes in appraisal practices, first, because there are no data justifying the need for change where the buydowns are correlated with rising defaults.

Second, because it would greatly exacerbate the affordability problem.

And, third, because it is impractical. Rather than simply going to a system where all financing is discounted from the value of the home, the market needs to decide what, in fact, are to be considered reasonable financing packages.

Any package within these parameters could be assumed to be part of the normal price of selling a home. This concept has already been accepted in the case of real estate commissions. Home buyers know that this cost has been included in the sales price and that they do not hope to recapture it immediately.

Specifically--and this is the last illustration—3-2-1 percent builder buydown is an example of what we consider to be a safe program. A lot of people don't understand buydowns, quite frankly.

A 3-2-1 percent buydown allows the borrower to qualify for a loan—usually a fixed rate loan—at 3 percent below the market rate. However, to assure the safety of the loan, the builder actually places funds in escrow to cover the difference between the interest rate paid by the borrower and that required by the lender.

The increases in monthly payments paid by the borrower are defined ahead of time so that the borrower knows them and money is set aside to cover the increases as far as the lender is concerned.

Should the borrower prepay on the mortgage or default on the loan, those loans remaining in the escrow account are applied to the loan principal. This practice counteracts any difference in price that might have occurred as a result of favorable financing.

We're delighted to have the opportunity to testify. Naturally if there are any questions, we'd be glad to answer them.

[The complete prepared statement follows:]

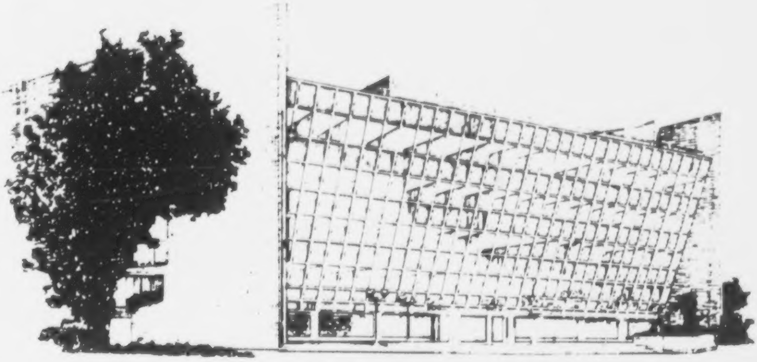
Statement of the NATIONAL ASSOCIATION OF HOME BUILDERS before the

Committee Banking, Housing and Urban Affairs/Subcommittee on Financial Institutions/United States Senate

Subject Adjustable Rate Mortgages

Witness Kent W. Colton, PhD

Date Friday, April 19, 1985
Place 538 Dirksen Senate Office Bldg.



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Washington, D.C 20005
(202) 822-0470

STATEMENT OF

THE NATIONAL ASSOCIATION OF HOME BUILDERS

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS

U.S. SENATE

on

ADJUSTABLE RATE MORTGAGES

April 19, 1985

Mr. Chairman and Members of the Committee:

My name is Kent Colton and I am Executive Vice President of the National Association of Home Builders (NAHB). I am testifying on behalf of the more than 131,000 members of NAHB, a trade association representing the nation's homebuilding industry. I would like to thank you for the opportunity to appear before your Committee and testify on Adjustable Rate Mortgages (ARMs).

INTRODUCTION

As you know, the nation's housing finance system has evolved rapidly in recent years, driven by deregulation, innovations in financial markets and technological advances in the mortgage delivery system. A year long study which produced NAHB's Long Range Planning Report, Housing America: The Challenge Ahead, concluded that this process has moved the nation toward a more flexible and resilient housing finance structure, and that some of the financial and technical innovations, particularly with respect to ARMs and other primary and secondary market instruments and institutions, could contribute to lower costs of mortgage credit for borrowers. Mortgage markets generally operate more efficiently than in the past, and mortgage "availability" problems are largely a phenomenon of the past. This does not mean, however, that housing has been protected from shifting credit market conditions. The channels of impact have been changed, but the sensitivity remains. The real issue now is no longer the "availability" of mortgage credit, it is the affordability of mortgage credit.

Changes in the economic environment, as well as in various institutions and technologies, have affected the cost of home mortgage credit in private markets and the ability of prospective home buyers to qualify for loans. The economic changes include a sharp decline in the rate of inflation since the beginning of the 1980s, coupled with with a resulting slowdown in the increase in home values -- a process known as "disinflation" -- and a marked increase in the short-run variability of market interest rates. One major institutional innovation affecting affordability has been a dramatic rise in the incidence of adjustable-rate mortgages in the wake of changes in laws and regulations that have facilitated this development.

Equally important has been growing consumer acceptance through the development of ARM designs that generally try to balance the needs of the borrower and lender. Important progress has been made, and finetuning is still occurring in the market place. These adjustments are the best arguments against attempts to over legislate or over regulate.

Building on this understanding of the evolution which is underway, this testimony will now outline the benefits of ARMs, identify the key issues to be addressed, discuss NAHB policy on ARM's, and set forth recommendations for the future.

BENEFITS OF ARMS

Affordability One of the primary reasons NAHB supports ARMs is because, if they are designed correctly, they can contribute to housing affordability. As noted earlier, housing affordability continues to be one of the most significant issues facing our industry today and is largely the result of high financing costs, both for home mortgages and for construction loans.

This situation is doubly frustrating for the nation's home builders because of the large number of potential new home buyers. Some 41 million Americans are expected to reach the prime home-buying age of 30 during this decade and 15 million are graduating from college. How many of these young Americans will be able to realize the dreams of home ownership?

A 1984 NAHB survey of college students indicates that buying a home remains a top personal priority for most students, but college students fear that high mortgage interest rates and home prices may prevent them from ever achieving that dream.

The extreme sensitivity of housing affordability to changes in mortgage interest is illustrated by the following table:

Sensitivity of Housing Affordability to Change in Mortgage Interest Rates

Mortgage Rate	Monthly Payment	Required Annual Household Income	Qualified Households (millions)
9%	$521	$25,008	39
10	569	27,312	34
11	617	29,616	31
12	667	32,016	27
13	717	34,416	24
14	768	36,864	21
15	819	39,312	18

Source: Joseph Hu, Salomon Brothers

This table tells much of the story. ARMs have become increasingly popular, for some homebuyers, because they are more affordable. Speaking in approximate terms, when ARMs are offered at an initial interest rate which is 2%-3% lower than the rate for a fixed rate mortgage, they achieve a monthly payment which is approximately $150 per month lower, and they allow 8-10 million more households to purchase a typical home. These households want to purchase a home, in order to achieve the dream of homeownership and to begin to build equity, so they accept an ARM.

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* Housing affordability is a measurement of the number of households with the income necessary to qualify under the prevailing mortgage interest rate for a mortgage loan to purchase a median-priced new house. The criterion for determining the required annual income is that 25% of the income should be sufficient to cover the annual mortgage payment of principal and interest. The mortgage loan assumes an 80% loan-to-value ratio with a 30-year amortization period. The following assumptions were used for 1984: The median sales price of a new house is $81,000; household income increase 7% across the board over the 1983 distribution; and the number of households increase 2% over 1983.

Impact on The Housing Cycle In addition, it appears that ARMs have played a role in moderating the housing cycle. Home buyers are more willing to accept an ARM in a high interest rate environment if they know they will benefit from anticipated future declines in rates. Similarly, lenders do not need to try to build anticipated future interest rate increases into current prices. By helping to moderate the housing cycle and spread production more evenly, ARMs contribute to a more efficient, cost effective industry.

However, it is clear that the proportion of ARM volume will depend on the overall level of interest rates and the differential between short and long term interest rates. In fact, Chart 1 illustrates that fixed rate mortgages remain the instrument of choice for consumers when interest rates are at a more moderate level. ARM activity was relatively higher in 1982 when rates were higher, but there was a decline in ARM origination from late 1982 to mid-1983 when FHA rates ranged from 11.5 percent to 12.5 percent. Even though T-bills and the ARMs tied to them were lower still, many home buyers judged the fixed rate mortgage "affordable" again and opted for it. However, in August 1983, the FHA rate jumped back up to 13-1/2% and ARM activity climbed significantly. The trend was intensified by low discounted initial rates offered by ARM lenders. This continued until last fall.

Then -- once again -- as interest rates declined in the fall of 1984 the number of ARM originations also declined because homebuyers were selecting fixed-rate mortgages. The Federal Home Loan Bank Board reports that ARMs accounted for only 46 percent of conventional loans closed in early February, down from a high of 68 percent last August. However, if interest rates edge up, consumers are expected to shift back from fixed-rate loans to ARMs.

This trend indicates to us that the market-place is working and that adjustable interest rate mortgages provide consumers with viable alternatives to fixed-rates. ARMs are bridging the affordability gap for purchasers -- especially during periods of higher interest rates.

The Importance of ARMs to the Thrift Industry While most consumers choose ARMs for reasons of affordability, thrifts originate ARMs as a preferred investment in hopes of better matching their assets and their liabilities. A high percentage of thrift deposits is short-term "hot" money that cannot safely be dedicated to long-term fixed rate investments, such as traditional mortgages. Thus, when deregulation allowed thrifts to offer competitive rates for the borrower and to recapture many of their lost deposits, they began actively marketing ARMs.

ARMs were seen as the only way thrifts could both remain in housing and remain solvent. Their job was made easier by a steepening yield curve. The difference between short and long rates was increasing because investors were anticipating further interest rate increases and going "short." Thus ARMs became widely available at prices that made sense to home buyers. The existence of ARMs has enabled the thrift industry to resume its role as the nation's primary mortgage originator and investor (see Chart 2).

Over the longer term, however, the continued acceptability of ARMs to consumers will depend on designs that offer not just a lower interest rate compared to the fixed-rate mortgage, but a lower qualifying ratio and reasonable terms later on. This requires balancing the lender's desire for interest rate sensitivity with a realistic assessment of the borrower's ability to absorb payment increases.

ISSUES

Mr. Chairman, despite the many benefits of ARMs, we also recognize at NAHB that they are not without problems. Currently, there are at least four major issues or questions that the Congress should be aware of:

(1) Is the market regulating itself or should Congress or other federal regulators prescribe standards?

(2) Does the consumer understand the product and have sufficient information to evaluate his or her options?

(3) What are the credit risks associated with ARMs?

(4) Not related solely to ARMs, but to the more general issue of underwriting in a less inflationary envirnoment, to what extent are the quality and methodology of appraisals adequate or inadequate?

I would now like to review these four issues in greater detail and then make specific recommendations concerning the future.

Market Regulation Since introduction of the adjustable rate mortgage, the market has been searching for a product with characteristics that balance the needs of lenders, investors and borrowers. The process has occurred largely on a trial and error basis -- some products were rejected by home buyers while lenders or investors found other characteristics unacceptable. The key factor (and most difficult factor) to market acceptablility is balancing all of these interests in a single product.

Initially, adjustable interest rates were introduced to protect the financial institutions. The thrift industry was under pressure to better match their short-term borrowing against their long-term mortgage lending. The introduction of largely untested ARM products was intended to boost sluggish earnings by providing the thrift institutions with an alternative investment to the fixed rate mortgage. The lower initial rates offered by ARMs were viewed as a means of allowing more buyers to qualify while the adjustability feature was seen as a way to keep thrifts solvent. As a result some of the early experimental products were less quality conscious than more recent ARMs. Underwriting standards were often more relaxed and many financial institutions were qualifying the purchasers at deeply discounted rates. However, if rates adjust upward these loans carry potential for payment shock.

Fortunately, most all of these undesirable qualities have since been rejected by the market. It has only been recently that we've begun to establish a track record that will allow a "finetuning" of these instruments.

Acceptablility is also influenced by the economic conditions at the time and place the financing is offered. Thus the market may shift back and forth among one-year, three-year, five-year ARMs and fixed-rate loans. A one-year ARM tied to a one-year Treasury index is currently the most widely used ARM. And the industry seems to have moved to a two percent annual interest rate cap coupled with a five percent or six percent life-of-the loan cap.

The FHA-ARM with its one percent annual interest rate cap is viewed as too restrictive by investors. Consequently, there has been little use of this program. Only 300 loans have been originated since the program began in August. Unfortunately, the FHA program cannot be adjusted easily since its parameters are set by legislation.

Other market participants have revised their ARM programs in response to changing market conditions. For example, when use of Fannie Mae's payment cap program dropped to very a low level, FNMA was able to adjust and follow the market to interest rate capped programs. (See Chart 3)

The key parties involved in the mortgage finance process are together fine-tuning the various characteristics which have been offered to date. Through this selection process, the market seems to be self-adjusting and thus defining the acceptability of different products. This process of self-analysis and self-correction will continue as market conditions warrant and as new products are offered. In fact, we estimate that over the past year the most objectionable qualities found in the early ARMs products have essentially been eliminated.

Consumer Information and Uniform Arm Disclosure Home Builders are increasingly becoming aware of the mortgage finance area. The availability of affordable home mortgage money is a prime determinant of the level of homes built nationally and in a particular local market.

Of special of concern to the builder, is his own share of that market. The builder normally has no stake in the type of mortgage offered beyond trying to provide what his customers want and can afford. Arranging mortgages for customers is normally a cost to the builder, which in competitive markets may be difficult to pass on to the home buyer. At the same time, however, the builder has no choice but to offer financing that is at least as competitive as what others are offering in the market place. This dilemma is a major reason why the National Association of Home Builders policy has always emphasized the need for standardization, as well as for consumer safeguards.

Last summer, NAHB testified before the House Banking Subcommittee on Housing and Community Development on the need, not only for consistent consumer education of ARMs, but especially for uniform borrower disclosures. We stated then that because the Federal Reserve, the Federal Home Loan Bank Board and the Comptroller of the Currency each have their own ARM disclosure requirements with which their respective regulated institutions must comply, consumers could not compare these three different disclosures even for the same loan.

In addition, we pointed out that these competing and conflicting disclosures are impeding the development of an efficient secondary market for ARMs because both the FHLBB and OCC prohibit the purchase of an ARM that was not orginated using that agency's disclosure, even if the originating lender is not subject to that agency's regulations.

The net effect of these three competing disclosures is not to improve the information to the borrower. Instead, the effect is to add to the borrower's confusion, to the lender's confusions, and to the cost of compliance that is ultimately borne by the borrower.

As a result of the hearings held at that time, Congressmen Gonzalez and McKinney wrote to Chairman Volcker on August 6, 1984 requesting the development of an industry-wide consumer education brochure. Also in that letter is a statement that "in order to avoid confusion among mortgage lenders and to better clarify the terms of the mortgage instrument to the home purchaser, one uniform disclosure form must be developed by the Federal Reserve Board in conjunction with the other regulatory institutions . . ."

As you know, the consumer education brochure was published within six months. However, little action has been taken with respect to a uniform disclosure document.

The Federal Financial Institutions Examination Council, composed of the heads of the federal regulatory agencies, has been considering a uniform ARM disclosure since last summer. It is our understanding that the Council has dropped its efforts and asked the Federal Reserve to resolve the matter. It is also our understanding that the Comptroller and the Federal Home Loan Bank Board prefer their competing disclosures and do not wish to change them. We find this regrettable because it reflects a lack of concern for the needs both of borrowers and of the institutions for which these agencies are responsible.

The need for a uniform ARM disclosure has been recognized and suported by virtually all real estate industry groups. We urge the Congress to reinforce the need for these three agencies -- the Federal Reserve, Federal Home Loan Bank Board, and the Comptroller of the Currency -- to cooperate and to develop a uniform ARM disclosure within six months.

In conjunction with the need for a uniform disclosure, is the question of content of such disclosure. Although NAHB does not intend to comment in detail on the content in this testimony, we do want to point out that there are some who have suggested that special financing costs, as reflected in the house price, should be disclosed in Regulation Z as part of the finance charge. We think this would be a mistake, and further, it would be impossible to enforce.

Several years ago, with the surge of creative financing techniques resulting from high interest rates, the Federal Reserve considered a Reg Z disclosure regarding the premium in the sales price charged for such things as buy-downs, seller-take-backs and low-rate assumable loans. The Board determined at that time that disclosing a sales price premium as a finance charge was unworkable because it is virtually impossible to determine the amount of the premium on a consistent basis. We agree it would be impossible to determine whether all, some or none of the financing costs were included in the sales price of the house, particularly when so many other market factors unrelated to financing affect the price of a house.

Credit Quality Despite the safeguards contained in today's ARMs, delinquency and foreclosure rates are up nationwide, and this poses serious questions for everyone from the consumer to those who ultimately invest in the loans. The severity of losses being experienced throughout the lending and insurance industries exceeds anything seen since the depression.

However it is also important to put these losses in perspective. Many of these defaults are in mortgages issued several years ago and therefore we have to be careful not to equate that experience to what is happening now. The primary cause for the losses is a lack of signficant appreciation -- and in some cities significant depreciation -- in real estate values, which compounds the problem of unemployment associated with any recession.

The original recession that devastated the Great Lakes region has now been followed by an "energy bust." The impact is especially severe in cities, such as Houston, that had seen very high levels of construction recently. As a result, while FHA's losses appear to have peaked, private mortgage insurance losses continue at high levels. The problem is intensified because insurers were pricing premims as if the risk on loans was similar. The adoption of tiered premiums should begin to pay off in healthier loss-to-premium ratios. Most companies increased fees last year and further increases in both rates and underwriting standards are expected.

In a disinflationary environment such as we are currently experiencing, neither home prices nor wages appreciate rapidly. As a result, affordability is not merely a problem of initial qualification. Mechanisms, such as low down payment graduated payment mortgages, that pay for lower initial payments with negative amortization no longer work well because the lack of accumulated equity subsequently produces higher foreclosre rates.

Reactions have ranged from a general tightening in underwriting guidelines and increases in mortgage insurance premium, to suggestions that the appraised value of a home be adjusted to reflect financing costs or that the five percent downpayment loan be eliminated.

Certainly a re-evaluation of mortgage programs is in order. However, it is important to carry out the re-evaluation with care and based on an analysis of the facts, not just the rhetoric. First, we need to assess to what extent current problems are a result of a particularly severe recession. For example, FHA experience is that loans made in 1981 and 1982 have extremely high delinquency and foreclosure rates, while those made in 1983 and 1984 are above average in quality.

Second, it is vital that we analyze what types of loans typically go into foreclosure and take a more careful look at the elements of those loans, and how those elements interact with each other. For example, it is clear that a five percent down loan is more risky than a 10 percent down loan. But to completely eliminate the five percent downpayment poses an unacceptable threat to home affordability. FHA has managed to run a profitable program in which a large percentage of loans have downpayments in the range of three to five percent. Provided that mortgage insurance premiums and underwriting controls are properly set to take the extra risk into account there is no reason that the 5 percent down conventional loan cannot be profitable as well.

Most losses that are occurring now involve fixed rate mortgages and it is too early to tell whether ARMs will compound the problem. In general, it appears that the types of interest rate capped ARMs being originated today will not experience higher foreclosure rates than comparable fixed rate mortgages. However, this is just one of many areas where we lack solid data. A March 1985 analysis by Moody's Investors Service compares loan defaults in 1980-83. ARM default rates were initially higher, but then dropped off. However, these ARMs were mainly three and five year ARM's and are not strictly comparable to today's product.

Appraisals and Buydowns In recent months, the issue of appraisals has been raised especially by the mortgage insurance industry. They have mounted a rather vigorous campaign, first, with the appraisal industry and then with FNMA and FHLMC to change longstanding appraisal practice so as to lower appraised values. Their purpose is, of course, to reduce the level of indebtedness permitted on a particular property, thereby limiting the insurer's exposure in the event of default. Reducing the appraisal would allow them to accomplish this with only a minor reduction in the amount of the premium they collect.

Much of the original dialogue focused on changing appraisals from a measure of current market value to one of liquidation value. Under this approach, appraisals, and hence mortgages, would be limited to the value that could be obtained under duress. More recently discussion has shifted to a concept of "cash equivalency." A cash equivalent system bases the home value on the price that a third party would pay if he or she did not have access to special financing.

NAHB opposes this change in appraisal practice because first, there is no data justifying the need for such a change; second, because it would greatly exacerbate the affordability problem; and, third, because it is impractical. We have discussed these points with a number of the parties involved -- especially FNMA, FHLMC and the appraisal societies -- and they seem to realize the need to move cautiously in this area.

Questions have been raised regarding the effect of financing concessions on the price of a new home and on the ultimate security of the loan. We would like to clear up some of the misunderstanding that has developed regarding this issue. Provided that financing breaks are at a resonable level, and are typical in that market, they should have little impact on the price of a home.

The 3-2-1 buydown is an example of what NAHB considers to be a safe program. A 3-2-1 buydown allows a borrower to qualify for a loan, usually a fixed-rate loan, at three percent below the market rate. The builder places funds in escrow to cover the difference between the interest rate payed by the borrower and that required by the lender. Increases in monthly payments are manageable and known well in advance.

Should the borrower prepay on the mortgage, or default on the loan, those funds remaining in the escrow account are applied to the loan principal. This practice counteracts any difference in price which might have occurred as a result of favorable financing.

Rather than simply going to a system where all financing is discounted from the value of the home, the market needs to decide what in fact are to be considered reasonable financing packages. Any package within these parameters could be assumed to be part of the normal price of selling a home. This concept has already been accepted in the case of real estate commissions. Home buyers know that this cost has been included in the sales price and that they cannot hope to recapture it immediately.

Certainly buydowns cost money. NAHB would submit, however, that providing affordable financing has in many cases become part and parcel of delivering homes to the consumer. This practice is not limited to the new home market. It is not at all unusual for a home seller to pay points or to offer to take back a mortgage at a more favorable rate than that available from mortgage lenders. Nor is it unusual for a seller to offer other concessions or to wait out the market until rates fall to a more favorable level. Should the value of these homes also be adjusted to reflect what they would bring under less favorable conditions?

In theory it is possible to figure out to what degree financing may have affected the price by pairing the home under consideration with a similar home that involved no special programs. In practice, it is very difficult to determine what method was indeed used to finance the comparables, especially when the financing options vary widely in a given area. This is particularly difficult in a market where interest rates are unstable. In some cases, as with homeowner/builder bonds, the builder may not even know what the financing package will cost until weeks or months after the mortgages have been originated.

Moreover, it is difficult, if not impossible, to determine to what extent the builder or seller of the home has been able to pass on the costs to the buyer. Certainly, in most cases, some of these costs have been taken from profit margins, especially during times when the market for sales is poor.

NAHB is aware that some excesses have occurred and that not all financing plans have provided for a sufficient degree of safety. We strongly believe, however, that these abuses have been the exception rather than the rule. Despite frequent requests, we have never been shown anything but anecdotal evidence concerning buydowns.

In fact, NAHB has sought information from a variety of sources on what types of loans typically cause problems. To date we have been unable to gather any data indicating that there is a correlation between builder buydowns and mortgage delinquencies. So far, the only data we know of have demonstrated what we already know: that 95 percent loan-to-value ratios are more risky than loans involving 90 percent loan-to-value ratios; that loans involving negative amortization are more risky than those without; that most losses are concentrated in depressed geographic regions; and that one mortgage insurer, suffered serious losses as a result of an aggressive second mortgage program, with relaxed underwriting guidelines. There is a desperate need for data that better breaks out the characteristics of each loan type and analyzes the various factors which lead to problems. NAHB plans to gather such data and would like to work with others in the industry to this end.

We are concerned, therefore, that some in the industry have pointed to builder financing plans as the prime example of problem loans, when it seems clear that they are not the cause of the problem. In fact, it seems that excessive rhetoric may be an effort to divert attention from the real problem -- a failure to do quality underwriting.

It seems clear that there is no statistical information that shows that customary buydowns are a major cause of foreclosure loss. Thus it would not be justified to change longstanding appraisal practice to take account of them.

What has been a factor in some forclosures, however, are sloppy or even fraudulant appraisals. The solution to this problem is better quality control. The appraisal industry is a rather fragmented one. Although appraisal is highly technical, there are no licensing requirements. The majority of appraisers do not belong to either of the two largest professional groups. Thus, the enforcement of consistent appraisal standards becomes a hit-or-miss situation that allows incompetent or dishonest appraisers to slip through the cracks. NAHB has been working with FNMA, FHLMC and the appraisal societies to see what improvements can be made in this area.

NAHB POLICY ON ARMs

At the 1984 Spring Board of Directors Meeting, NAHB reviewed its policy position on ARMs and adopted the following resolution:

> NOW, THEREFORE, BE IT RESOLVED that the National Association of Home Builders support graduated payment and partial buydown features as essestial to ARM affordability, especially in periods of abnormally high interest rates while, at the same time, avoiding extreme practices that could be dangerous to the consumer,
>
> BE IT FURTHER RESOLVED that NAHB reaffirm its policies in support of full and easily understood disclosure and appropriate borrower safeguards, and
>
> BE IT FURTHER RESOLVED that NAHB recognize the need for a balanced policy with respect to buydowns to assure their continued existence but to eliminate extreme payment and interest rate increases, and

BE IT FURTHER RESOLVED that NAHB welcome recent action by secondary market entities to address this issue and direct the NAHB staff to work with lenders and secondary market agencies in: (1) developing balanced, standardized program designs that can withstand periods of rising interest rates while, at the same time, continuing to enhance affordability; (2) promoting full compliance by lenders and builders as set forth in disclosure requirements; and (3) furthering the consumer education process.

We believe that this resolution has withstood the test of time. It strikes a balance between the needs of lenders for both interest rate sensitivity and sound underwriting and the need of home buyers for affordable mortgages. Applying these principles to the current situation we would like to make some specific recommendations in areas of concern to the Congress.

RECOMMENDATIONS

(1) Market Regulation We believe that the market has worked remarkably well in the past year and that Congressional action at the present time to impose particular designs (or consumer safeguards) would be counter-productive. Recent improvements have resulted from a combination of heightened consumer understanding and more careful underwriting on lenders and insurers.

(2) FHA - ARM We urge this Committee and the Congress to support changes to the FHA - ARM program that will increase market acceptability. Specifically, an annual interest rate cap of two percent should be permitted, and FHA should be encouraged to conduct futher program development concerning the use of FHA insurance for alternative mortgage instruments, especially mortgages which focus on affordability.

(3) Uniform Disclosure We urge the Congress to strongly encourage the Comptroller of the Currency and the Federal Home Loan Bank Board, along with the Federal Reserve Board, to establish a uniform disclosure document. However, the benefits of true uniformity and comparability should not be lost by a problematic attempt to incorporate seller financing concessions.

(4) Credit Quality In today's environment, careful underwriting is crucial. This can be achieved with a minimum impact on affordability if mortgage insurers and lenders concentrate on enforcing existing standards, rather than changing the rules arbitrarily. Much more data is needed and NAHB, for one, stands ready to cooperate in gathering data. Changes to longstanding criteria should not be made unless there is sufficient information to demonstrate that the item is relevant to foreclosure rates.

(5) Appraisals NAHB supports efforts to improve the quality of appraisals, for example, by using professional designations, but it is strongly opposed to efforts to lower appraisals -- thus have a major impact on affordability -- through an

across the board change in the rules. Once again, there is no evidence that inflated appraisals are a general problem. The evidence is that a limited number of fraudulant appraisals have caused some spectacular losses. The solution must be to eliminate the unreliable appraisals and institute quality controls -- not to totally change the rules of the game.

CONCLUSION

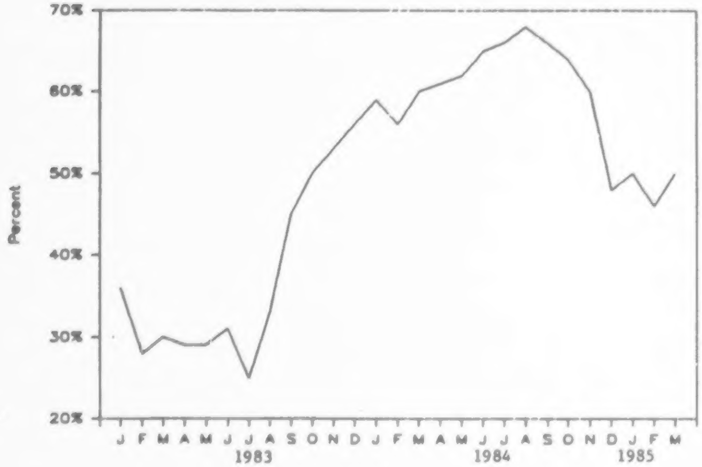
As I hope my testimony has made clear, we at NAHB do not feel that today's ARMs are a cause for concern, but when implemented correctly a useful element toward achieving housing affordability. We are, however, somewhat concerned about the impact of disinflation combined with unprecedentedly high real interest rates on housing affordability. Also there is a danger that the pendulum will swing too far the other way and that lenders and mortgage insurers will over-react with a wholesale rewriting of the rules governing mortgage eligibility, unnecessarily depriving large numbers of households of the opportunity to become home owners.

At the same time, we are trying to be as supportive as possible to changes which address the problems in the marketplace and are justified by good information. For example, we expect that the mortgage insurance industry will be able to overcome its problems, correct some of the mistakes that were made in the past and return to good health. However, we have to remember that the big goals are a healthy housing finance industry as a whole, while at the same time meeting the needs of today's homebuyers for the most affordable, cost-effective financing possible. At a minimum, we must continue to maintain strong and aggressive FHA and GNMA programs.

Mr. Chairman, thank you for inviting NAHB to tesify and I would be pleased to answer any questions that you or other Members of the Committee have.

ARM SHARE OF HOME LOANS CLOSED *

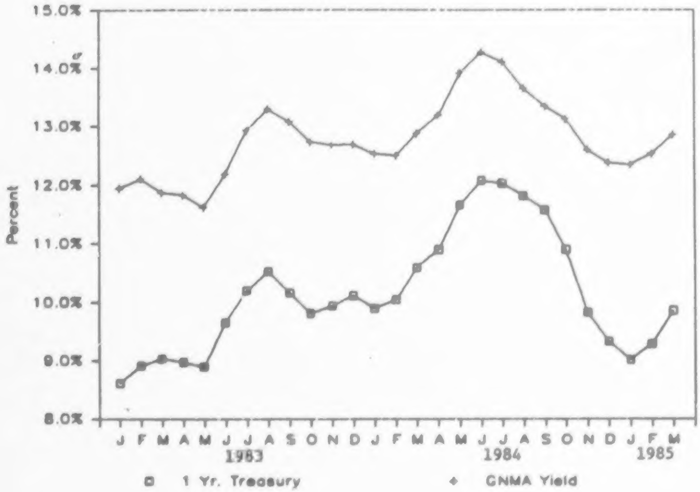
CHART I



* Conventional mortgage loans closed by major lenders.

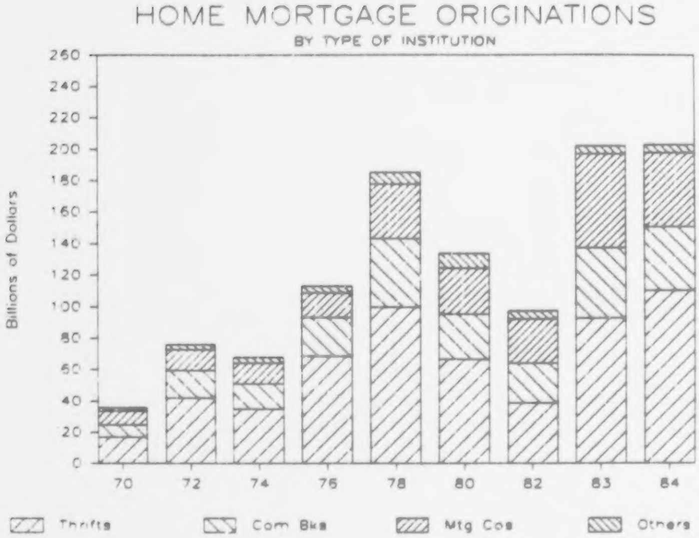
SOURCE: Federal Home Loan Bank Board

1 YEAR TREASURY VS GNMA



SOURCE: Board of Governors of the Federal Reserve and MGIC

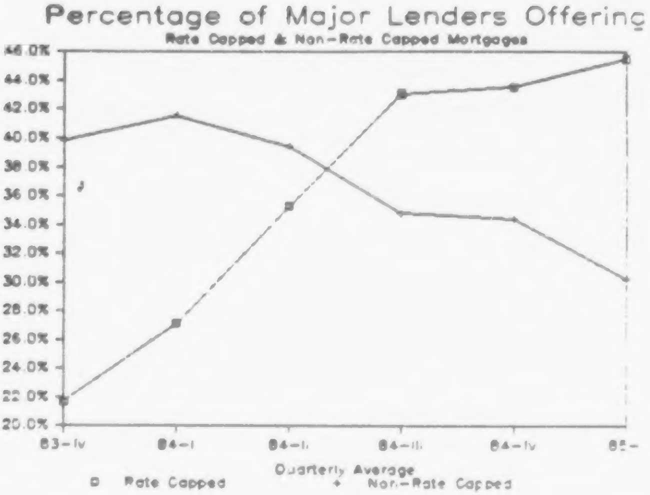
CHART II



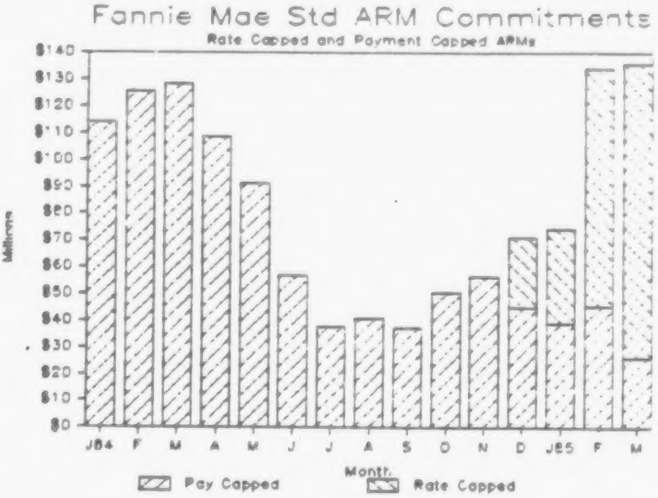
NOTE: 1984 figures are estimates based on 11 months' data. Data include originations of long-term non-farm residential mortgages (excluding construction loans) by 10 types of institutional lenders.

SOURCE: U. S. Department of Housing and Urban Development

CHART III



Source: Federal Home Loan Bank Board,
Federal National Mortgage Assn.



Source: Federal National Mortgage Assn.

INFORMATION AVAILABLE

Senator **Gorton**. During the course of the day, we've heard about several booklets which explain adjustable rate mortgages to consumers. Maybe two, three, or all of you would like to explain briefly how your members use these booklets and when they give them to consumers and how useful do you think they are?

Mr. **Lasko**. I'll start, Mr. Chairman, by saying our members simply distribute these booklets to loan applicants at the time an application for a loan is being made. The particular booklet here actually has a worksheet in it that provides a checklist of critical comments, a glossary if you will, that consumers should be aware of.

It gives them a worksheet where they can compare different loans and put them all on one worksheet where all the terms are the same across the board and it allows them, hopefully, to compare different options on an objective basis.

We think probably the glossary aspect of this is the most valuable element. One of the terms we haven't heard much about this morning but which is really quite important, perhaps more important than the 5-percent life of the loan cap, is the phrase margin. That is to say, how much is going to be added to the index at each adjustment period. And margins vary widely in the market from as low as 1½ percent over a 1-year Treasury to as much as 3½ or 4 percent. In any given market, at any given initial rate, that means that the second and later rates can vary by as much as 3 percent on the same index.

So, anyway, this booklet helps the home buyer or potential home buyer, work through that type of calculation.

Mr. **Beeksma**. Mr. Chairman, you heard the representative from the Bank Board testify earlier about the development of the "Consumer Handbook for Adjustable Rate Mortgages" which is just being made available.

Our use of this will simply be to have it available in our lobbies for distribution and hand out as people make applications for loans and it will be very, very helpful. It's very informative on the process of how to compare various loans.

Senator **Gorton**. That's the booklet you'll be likely to use?

Mr. **Beeksma**. This is the booklet we will use and it is very helpful in enabling them to compare the various ARM's and that seems to be the difficulty. Most people haven't understood about it to compare this. But this booklet will be a great help in that area.

In addition, of course, at the time of application we also disclose the terms of our own ARM, so this will be a big help and, of course, this will be required by regulation.

Mr. **Dunn**. Mr. Chairman, the council is in the process also of distributing that very same consumer handbook. Speaking for my institution, we will be using that in a similar fashion on the counter, hopefully, in a preapplication state. I think it's a very, very important booklet.

We also have utilized the MBA publication primarily in an education effort which we see as very helpful amongst the rest of the real estate community, not just consumers, but real estate brokers.

Mr. **Colton**. Mr. Chairman, I would like to make a quick comment on this topic. We have not put out a booklet. We have tried to educate our members and we use some of the materials mentioned.

We do feel—and I included a discussion of this subject in my testimony—that in the area of consumer information, the booklets are very helpful. In addition, it would be very helpful to have a common consumer disclosure document that would, in fact, reflect the interest of the Bank Board, the Comptroller of the Currency, and the Federal Reserve Board. That came up in the first panel and we think that Congress should encourage the regulators to continue to move in this direction and eventually to achieve a uniform disclosure document on ARM's.

Senator **Gorton**. Several of the organizations signed a letter last year proposing a statutory provision which would have prevented consumers from entering into ARM's with more than a 5-percent interest rate increase over the initial rate of the loan.

The letter states that this restriction—and I quote, "would significantly diminish the utility of adjustable rate mortgages."

Since most ARM's already contain such restrictions, wouldn't a statutory prohibition have almost no effect rather than significantly diminishing their utility?

NO NEED FOR LEGISLATION

Mr. **Beeksma**. Mr. Chairman, could I lead off? I was going to develop in my comments, the fact that in today's interest rate environment, I don't think the 5-percent cap is a particular problem.

My concern is that there's a very real possibility interest rates will decline and when that occurs, then the terms of our notes will have to change because of the probability of change as far as what can happen to that loan. That's our concern.

We think—my institution feels that a legislative cap of 5 percent very possibly could foreclose mortgage lending opportunities for us.

Senator **Gorton**. Does that extend to any statutory restrictions on ARM's?

Mr. **Beeksma**. I would say any statutory restriction would simply be triggered at a different level. So it would apply to any statutory restriction.

Senator **Gorton**. Mr. Lasko.

Mr. **Lasko**. If I may. As we testified, we feel that there is no need at this point to legislate such caps. Let me make two observations in that regard.

One, to legislate a 5-percent cap, for instance, would give the illusion of protection without really providing protection in a great number of instances. As you already heard, of course, about 90 percent of today's ARM's have a 5-percent life of the loan cap or better.

There are instances, though, where consumers can be harmed even if there's a 5-percent life of the loan cap. For instance, usually a 5-percent life of the loan cap is coupled with a 2- or 2½-percent annual cap. That annual cap may well provide the real protection.

Even if a family can afford a certain increase in payments each year, it probably couldn't afford a 5-percent jump in 1 year, for instance. And to simply legislative a 5-percent cap would, as I say, give the illusion of protection but would not protect against shorter term jumps or against, for instance, abusively wide margins that I referred to earlier.

We certainly don't propose that you try to legislate all those angles. The ARM is an evolving instrument. We think the market has done remarkably well in a short period to encompass them.

And a second and final point I want to add. You should not ignore the 10 percent who are taking uncapped ARM's. Just to relate something I actually ran into the other day—a former official at HUD who has moved on and is shopping for a house, was calling us and telling us about the types of ARM's he faced. Finally, the most attractive one in terms of the initial interest rate and the low number of points that would have to be paid, was the totally uncapped ARM. This was an individual who understands the menu, can afford substantial changes in the payment, but was enticed by the low initial rate and the low number of points if he were willing to take an uncapped ARM.

In other words, the lender is saying everything has a price and I guess we would say we don't think that kind of individual should be deprived of the opportunity to take advantage of a product that the market offers.

Senator GORTON. Mr. Dunn, you wanted to comment?

Mr. DUNN. Mr. Chairman, I could echo the comments that have already been made. In today's interest rate environment, we feel that a 2- and 5-percent cap makes perfect sense, but considering the volatility we've seen in interest rates, we think that to legislate those caps would be a serious mistake. And to also echo what Mr. Lasko just said, we really do believe it would limit some very good product availability to the consumer or limit the choice that's there today.

Senator GORTON. The three of you, what are the features of your most popular, most used ARM?

Mr. DUNN. We offer a 1-year adjustable rate mortgage tied to the 1-year Treasury with 2- and 5-percent interest rate caps and no payment caps.

Mr. BEEKSMA. Our most popular one is an ARM that has a 2¾-percent variance each 6 months or a maximum of 1½ percent a year on a 5-percent outside cap, and a 1-year buydown. That seems to ease the transition and seems to be popular as well.

Mr. LASKO. Our members in good part are selling their adjustable rate loan productions to Fannie Mae and Freddie Mac. So they're looking at the products Fannie Mae and Freddie Mac offer. About 90 percent of them are 1-year adjustables based on the Treasury index with about a 2½-percent markup and 2- and 5-percent caps.

Senator GORTON. Mr. Colton, some of the teaser rate adjustable rate mortgages were apparently offered by the homebuilders. These are the mortgages which got a great deal of attention from the newspapers and comments elsewhere as well. Are they a good idea or do they offer too great a possibility of a huge payment shock to the home buyer and does your organization work at all to prevent ARM's which lack consumer protection?

Mr. **Colton**. I'm glad you asked that question, Mr. Chairman, because I think there's been a lot of rhetoric in the marketplace and it's important to try to clarify some of these issues.

EXCESSIVE BUYDOWNS

First of all, the primary manifestations of what I would call excessive buydowns occurred in 1984 and earlier when people were very anxious to sell a product. But they were primarily in selected areas of the market where the economic situation was particularly troublesome.

NAHB 1 year ago, recognized that was an issue and, as I indicated in our testimony, we brought a resolution before our entire board which we not only communicated to the Hill, but we talked about internally in our organization. We noted the fact that buydowns, if they are done in a reasonable manner, are important in the marketplace with respect to affordability but that excesses, in fact, do need to be eliminated and ended.

So with that in mind, we applauded the efforts that were occurring with some of the secondary market agencies, particularly Freddie Mac and Fannie Mae, who tried to rethink their underwriting practices.

The membership, particularly the president and the senior officers of NAHB, have tried to communicate the need for affordability as well as underwriting concerns. I think it's important, though, to realize that these abuses really were the exception and not the rule, and that's why it was easy for that resolution to pass unanimously through NAHB.

It's important to not get carried away with the rhetoric in setting policy and to focus on a reasonable balance that talks about appropriate underwriting standards, which are appropriate and at the same time, remember that affordability is a serious problem.

Senator **Gorton**. Adjustable rate mortgages, obviously, have been hailed as a vital instrument in helping thrifts restructure their portfolios and decrease their risks. Now, it seems that they're pretty competitive and that rates are considerably below market in a number of parts of the country.

How can adjustable rate mortgages with 9 percent first-year rate and then 10 and then 11 percent, really help savings institutions?

What, Mr. Beeksma and Mr. Dunn, has happened in the last year, in your own experience? Are they highly competitive; are they really helping your institutions?

Mr. **Beeksma**. They're both highly competitive and really helping the institutions. I think you'll find, Mr. Chairman, in both of those cases of, let's say, below 11 percent, there's probably some kind of a front end buydown which also, of course, adds to the income. Most of the variables today, I think, are being offered somewhere around a floor of 11 percent. When you compare that to the cost of money today, in most institutions, it gives the satisfactory operating spread.

Mr. **Dunn**. I believe that really the teaser rates that everybody heard about in the early days of the ARM's have really gone by the boards. I can only really speak for our own particular market area.

The teaser rates really never dominated the market and it is a very, very competitive market. But I think the ARM's are appropriately priced.

Senator GORTON. For the two of you, and I guess Mr. Lasko, too, what percentage of ARM's now being originated have initial discounts and how deep, on the average, are these discounts?

Mr. BEEKSMA. In my own institution, most have original discounts for original buydowns and, typical, is just 1 percent for 1 year. This just seems to ease them in to their payments.

Mr. DUNN. In our institution, similarly, it's 1 percent.

Mr. LASKO. I happened to be looking the other day at some rate sheets for the local Washington area and a typical ARM in this area was going at an initial year interest rate of about 9½ to 10 percent, which looks low compared to the cost of money, but that is compensated for by points in the range of 2½ to 3 to 3½ points which, in effect, ups the initial years interest cost more to the 11 and 11½ percent range.

Senator GORTON. Are standards for qualifying people for ARM's with initial discounts different or more stringent than for a normal qualifying mortgage?

Mr. BEEKSMA. From our perspective, we normally qualify them at the initial rate but we also look very closely at the income projections for that individual. It appears that they're locked into a fixed income for a long period of time and they would not qualify at the margin, let's say. We want a comfortable margin on underwriting. If they look like they have a potential for income increase, they could probably qualify the marginal level at the additional rate.

Mr. DUNN. We qualify most of ours because we don't yield discount on that rate. We do tighten down our underwriting guidelines in terms of debt to income ratios for the higher loan to value loans.

Senator GORTON. OK.

I would like to thank each of you for helping us today. As you've heard, we'll submit additional questions from members of the subcommittee for you which we'd appreciate your answering as well.

[Response to written questions follow:]

1125 Fifteenth Street, N.W.
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Mortgage Bankers Association of America

Warren Lasko
Executive Vice President
(202) 861-6501

May 13, 1985

The Honorable Slade Gorton
Chairman
Subcommittee on Financial Institutions
and Consumer Affairs
U.S. Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This is in response to your request that we answer the following questions for the record of the hearings on adjustable rate mortgages (ARMs) that you chaired on April 19, 1985.

> 1. How clearly do you explain the existence of initial discounts to customers when they apply for ARMs? Do you tell them that their rate will go up even if interest rates generally are stable?
>
> 2. What standards do you use to qualify people for ARMs with initial discounts. Are they more stringent than your normal qualifying standards? Shouldn't they be?

1. MBA publishes "A Consumer Guide to Adjustable Rate Mortgages," which has been furnished free to consumers by MBA and by MBA members. Since it was published in August 1984, over 250,000 copies have been distributed. A copy of the Guide is enclosed.

The Guide devotes a full page (page 21) to the subject of below-market introductory rates. The Guide explains that an introductory rate that is considerably lower than rates on other ARMs is called a "teaser" rate. The Guide specifically warns: "In almost all cases, the teaser rate will adjust upward at the first adjustment to the more normal rates."

The new "Consumer Handbook on Adjustable Rate Mortgages," prepared by the Federal Reserve Board and the Federal Home Loan Mortgage Corporation, also devotes a full page (page 8) to the subject of initial discounts. MBA will be printing copies of this booklet so that our members can distribute it to prospective borrowers.

2. MBA believes that the standards being applied generally by mortgage bankers provide for underwriting the applicant's income and credit on both the initial discount rate and on the anticipated regular interest rate for the proposed loan. This approach is consistent with normal underwriting standards, properly understood.

To underwrite a loan as if the initial discount rate were going to continue for the life of the loan would be to ignore a known change in the required monthly payment, so mortgage bankers look at the applicant's current income with regard to the initial discount rate, and at the applicant's expected income at the time the initial discount will terminate.

I hope these answers have been of assistance to you. Once again, thank you for inviting us to participate in the hearing on the important subject of ARMs.

Sincerely,

Warren Lasko

Warren Lasko

USL
UNITED STATES LEAGUE of SAVINGS INSTITUTIONS WASHINGTON OFFICE
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PHILIP GASTEYER
Executive Director of Washington Operations
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May 15, 1985

The Honorable Slade Gorton
Chairman
Subcommittee on Financial
Institutions and Consumer Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Gorton:

This letter is in reply to your inquiry of April 30 to Mr. B. R. Beeksma, President and Chairman of the Board of InterWest Savings Bank of Oak Harbor, Washington, who represented the U.S. League of Savings Institutions in testimony on adjustable rate mortgages (ARMs) before your subcommittee on April 19. Your letter requested answers to five specific questions. Mr. Beeksma has supplied responses to the first two questions you raised. The responses to questions 3 through 5, which relate to matters industrywide, are provided by the U.S. League of Savings Institutions:

1. How clearly do you explain the existence of initial discounts to customers when they apply for ARMs? Do you tell them that their rate will go up even if interest rates are stable?

   Let me say first that we offer a wide variety of ARMS with varying initial fees, terms and adjustment periods. Borrowers can select from the various products offered the one best suited to their needs. Each loan has an "initial rate" which is in existence until the adjustment date. If there is a buydown from the "initial rate," then it is explained to the customer for just exactly what it is. Someone pays additional points up front so that a rate below the "initial rate" applies for a period of time. Borrowers clearly are aware of the "initial rate" which would have applied to their loan and the actual rate as a result of the buydown.

   In each case when there is a buydown, the borrowers clearly understand the "initial rate and the buydown rate. They also understand that at the end of the buydown period, the rate will go back to the "initial rate" assuming no change in the base.

2. What standards do you use to qualify people for ARMs with initial discounts? Are they more stringent than your normal qualifying standards? Shouldn't they be?

We use the "initial rate" to qualify borrowers for a loan without consideration of the buydown rate. Portfolio lenders certainly are not interested in delinquency problems and foreclosures. Not only do we require borrowers to qualify at the "initial rate" rather than the buydown rate, but we also apply more stringent qualifying standards to anyone securing an ARM as compared to a fixed-rate loan. We want to ensure that they have a potential to absorb increases in the interest rate should they occur. Yes, our requirements for qualifying for all ARMs are more stringent, but particularly for those with an initial buydown. They certainly should be, and I think you will find this is standard practice in the industry.

3. How significantly have ARMs contributed to any improvement in the condition of the thrift industry?

The heavy losses suffered by savings associations in the early 1980s forcibly brought home to the industry the need to restructure its mortgage loan portfolio if it was to survive the deregulation of its liabilities in a volatile interest rate environment. The ARM was seen as one of the principal tools in that restructuring of the balance sheet.

However, the balance sheet restructuring is not without cost. It can be viewed as the purchase of an insurance policy to protect the institution against rising interest rates and the purchase of that "insurance policy" costs money -- the difference between the rate on a long-term fixed rate mortgage and the rate on an ARM.

Furthermore, it is not only in the short-term that there is likely to be a cost to the institution of making ARMs. Since an ARM is less risky on average than a long-term mortgage -- and since short-term rates, to which ARMs are typically indexed, are usually lower than long-term rates -- one would expect, on average, that the ARM will yield less over its life than a fixed rate mortgage. It is only if interest rates rise substantially in the future that the ARM would be expected to be more profitable than the fixed rate mortgage and it is against such a contingency, which wreaked such havoc on the business in the early 1980s, that the industry has turned largely to making ARMs.

The forgoing line of argument can be stated more simply: if a business entity engages in a relatively low-risk line of endeavor it should expect relatively lower rates of return than if its activities were more risky -- but it can also expect a greater likelihood of remaining solvent in carrying out the less risky activities.

The answer to your question, therefore, is that the ARM is not intended to boost the short-run profitability of savings institutions but instead to help assure the long-term viability and stability of the industry. The benefit of the ARM to savings institutions does not necessarily show up in the bottom line but rather in some measurement that indicates a reduced level of risk in the business.

One such measurement is the so-called "one-year gap." Because of its complexity we have included a brief explanation attached as Appendix A to this letter rather than going through it in the body of the letter. We also show there that over the past year, there has been a slight but significant improvement in this measurement. The ARM is the main reason for this improvement and, indeed, in its absence, the exposure of the industry to increases in interest rates would have gotten worse because, given the uncertainty fostered in consumers by the huge federal deficits, the amount of total savings at our institutions held in savings accounts of one year or less has risen from 67% to 71% during 1984.

The significance of the ARM to the long-term health of the industry, therefore, lies in the gradual but steady improvement in this gap measurement of the exposure of the business to interest rate risk.

The economic reasoning underlying the switching of savings institutions to ARMs points out corollary benefits of ARMs to consumers. If an ARM is likely, on average, to be less profitable to a lending institution than a fixed rate mortgage, the opposite side of the coin is that it is likely to be less expensive to the borrower -- and this with limited risk exposure to the borrower. With the fixed rate mortgage, the lender took all the interest rate risk. The ARM has shifted some of this risk to the borrower but because of the consumer protections in the form of interest rate and/or payment caps typically built into ARMs, the amount of risk transfer is limited. The provision of such caps is analogous to a sort of co-insurance whereby the borrower accepts the first part of the burden of increases in interest rates but the lender then steps in if interest rates increase markedly. For picking up this affordable part of the risk, the borrower is compensated by a rate on the ARM which is likely to be lower, on average, than that on a fixed rate loan.

One final benefit that might be mentioned is the fact that the lower rates on ARMs have enabled homebuyers -- particularly first time homebuyers -- to purchase homes when many would have otherwise been shut out if they were dependent on fixed rate mortgages. Indeed, a noticeable difference between the housing in the United States and in foreign countries where adjustable rate mortgages have been the norm is that the boom/bust nature of the housing industry in the U.S. has not been as noticeable in other countries. Not only are borrowers more able to assume adjustable rate mortgages because of their typically lower rate, they are also more willing to take on an adjustable rate mortgage rather than a fixed rate mortgage in a high rate environment because, with an adjustable rate mortgage, they are assured that the rate on the loan will decline as interest rates decline.

Thus, the health of the housing industry in the United States over the past two years or so is directly attributable to the ARM. The high concomitant volume of mortgage loans is one factor that has helped reduce the cost of restructuring to our industry outlined above since institutions earn fees on the origination of loans. However, the fees from the additional lending do not fully offset the restructuring cost of the difference in rate between fixed and adjustable mortgage loans.

In sum, the bulk of savings institutions have returned to more healthy operating levels during the past year or so because of lower interest rates. The majority of institutions are using this opportunity to restructure their balance sheets using ARMs so that their earnings, while perhaps lower than in the 1970s, will be more stable in the future than in the first half of this decade. It is vital for the long-term well-being of the nation's home-financing delivery system that savings institutions be given a sufficient period of low and stable interest rates to complete this process.

4. Have ARM issuers been holding ARMs in their portfolio or have they been selling them off in order to continue issuing new mortgages and earn commitment fees?

For two reasons, savings institutions hold the great bulk of the ARMs they make in their own portfolios. In the first place, despite the much-publicized place of the secondary market in the nation's mortgage market, savings institutions as an industry put most of the mortgages they make in their own portfolios. Table 1 shows the amount of loans closed by our industry and the amount of loans sold. In 1984, the business closed $153 billion in loans and sold $59 billion (and as will be shown below, the business as a whole bought slightly more loans than it sold in 1984). Moreover, these sales figures are overstated because much of this activity consists of institutions selling their loans to FHLMC or FNMA and essentially getting back the same loans in the form of participations, which are more readily accepted as collateral for borrowing and are more saleable should the institution want to do so in the future. The introduction of these so-called "swap programs" is one of the reasons for the large increase in reported secondary market activity in the 1980s.

Furthermore, Table 2 shows that when savings institutions sell loans they are typically bought by other savings institutions. Thus, in 1984 the loan sales and loan purchases almost exactly offset each other. The only year when this pattern did not hold was in 1982 when the industry sold a lot of old low-yielding fix-rate mortgages in an effort to upgrade and restructure their balance sheets. The reason this occurred when it did was that it followed on the decision of the Federal Home Loan Bank Board to allow savings institutions, in the interest of upgrading their portfolios, to defer the losses arising from the sale of below-market loans.

The second major reason why savings institutions hold in portfolio the bulk of the ARMs they originate is that the secondary market has not been very successful yet in establishing an active market in ARMs. Fixed rate mortgages had been very homogeneous instruments and the secondary market in mortgages works best when it is faced with homogeneous product.

The ARM, with the many options available, has tended to localize the mortgage marketplace. Combinations of features are put together so that the loan best suits the characteristics of the local market. A broad-brush example of this phenomenon is the prevalence of payment caps and the resulting possibility of negative amortization in California while other markets tend to favor interest rate caps.

The secondary market has not yet learned to deal well with the resulting diversity of product. Moreover, it is somewhat doubtful whether the secondary market will ever fully embrace the ARM because many of the participants are not willing to accept the consumer protections that savings institutions are willing to give to borrowers. Thus, the typical plan of action of many savings institutions is that they make fixed rate mortgages for sale in the secondary market and make ARMs to hold in their own portfolios.

5. Do ARM issuers adequately consider a borrower's future credit worthiness since his income may remain constant in the face of significant increases in his mortgage costs?

The answer to this question follows somewhat logically from the discussion of the previous question -- the fact that savings institutions hold most of the ARM loans they close in their own portfolios means that they have a built-in interest in making sure that borrowers will not have problems in meeting payments in the future. The holding of loans in one's own portfolio as against selling them to a third party investor, who is perhaps located far from where the loan was originated, is the best assurance of quality in the underwriting and monitoring process.

(Note, along the same lines, that in the May 13 issue of Newsweek, the noted economist Albert Wojnilower of First Boston, in discussing the dangers of the growing "securitization" of debt in general in the United States, is quoted as stating: "Will anyone have the means and the incentive to monitor the financial behavior of the borrower after a loan has been made and sold?")

The determination of lenders to ensure that borrowers do not have problems in meeting their obligations lies behind the consumer protection devices that are built into most ARMs. Almost all ARMs have some kind of lifetime interest rate cap so that the interest rate on the loan cannot go above some specified level no matter how high interest rates in general go. Furthermore, to protect borrowers against violent year-to-year fluctuations in interest rates, most ARMs also incorporate some sort of interest rate or payment cap that limits the amount by which the borrower's monthly payment can change from year to year.

Finally one might point out that experience to date with ARMs shows that if anything the default and delinquency rates are lower than with fixed rate mortgages. Admittedly, ARMs have not yet been subject to the ultimate test -- what will happen when interest rates rise markedly? However, we have good reason to hope that borrowers will not be unduly pressed even in such circumstances, again because of the protections that are built into the vast majority of ARMs.

Furthermore, we should not be unduly surprised if ARMs turn out to have similar or even lower default rates than have been experienced with fixed rate mortgages. In some markets, the heated run-up in real estate values coupled with the availability of fixed rate mortgages, lead to a somewhat unhealthy speculative activity in housing in the late 1970s. Many consumers, wanting to participate in the tremendous leveraged profits available, overstretched in purchasing homes they could not afford. The heavy losses of the private mortgage insurance industry in the early part of this decade -- before ARMs were widely available -- underline this problem. To the extent that ARMs take away some of the inflationary windfall gains and, thus, have cooled off this speculative behavior means that we could very well see less default problems in the future.

Again the experience of foreign countries where adjustable rate mortgages have had a far longer history is instructive. In a recent survey of worldwide home lending finance, Mark Boleat of the British Building Societies Association made the following comment on the experience with ARMs in Britain in recent years (when, for instance, between June 1978 and November 1979, ARM rates, on existing as well as new loans, went from 9.75% to 15% -- a much greater change than would be allowed in such a short period with most loans in this country): "Perhaps surprisingly, the rapid increase in mortgage rates which (building) societies have been obliged to implement in recent years have not led to significant difficulties on the part of borrowers in meeting mortgage repayments". (Mark Boleat, National Housing Finance Systems: A Comparative Study, Croom Helm, London, 1985, pg. 52).

The U.S. League welcomes this opportunity to answer your inquiries. We are firmly convinced that the ARM is the most suitable housing finance vehicle in today's uncertain environment and we urge that the marketplace be allowed to develop the range of products that best meet the needs of providers and users of home financing. We stand ready to co-operate with you and your committee in any future inquiries you might have regarding the ARM and to share with you any pertinent information that our organization may develop.

Sincerely,

Philip Gasteyer
Executive Director of Washington Operations

Attachments

Appendix A

Measuring Interest Rate Risk at Financial Institutions

The measurement that has come into vogue recently for measuring interest rate risk among financial institutions is a technical measurement called the "gap" (interest-rate-sensitive asset minus interest-rate-sensitive liabilities). If more liabilities than assets can change in rate within a given period of time then the financial institution faces the possibility of losses if interest rates increase during that period of time.

The most common gap measurement used is the one-year gap -- the amount of assets whose rate can be changed within the next year less the amount of liabilities whose rate can be change within the same year. A resulting negative number would mean that increases in interest rates would be damaging to the bottom line of that institution.

For all savings institutions, the one year gap fell from -$58 for each $100 in assets at the end of the first quarter of 1984 to -$53 per $100 in assets at the end of the fourth quarter. This means that even by the end of 1984, the typical savings institution, for each $100 of its balance sheet, had $53 more in liabilities subject to repricing within a year than it had in assets that similarly repriced. Thus, the negative gap, while still substantial, is moving in the right direction.

TABLE 1: MORTGAGE LOANS ACQUIRED BY FSLIC-INSURED SAVINGS INSTITUTIONS

Year Closed	Loans Closed	Loans and Participations Sold	Sales as a % of Total Loans
1975	$53.8B	$5.2B	9.7%
1976	77.1B	8.4B	10.9
1977	105.3B	13.8B	13.1
1978	108.3B	15.5B	14.3
1979	98.7B	18.3B	18.5
1980	71.3B	15.9B	22.3
1981	52.3B	12.6B	24.1
1982	53.4B	53.4B	100.0
1983	132.4B	53.3B	40.3
1984*	153.2B	59.3B	38.7

*Preliminary

Source: Federal Home Loan Bank Board

TABLE 2: SECONDARY MARKET ACTIVITY OF FSLIC INSURED SAVINGS INSTITUTIONS

Year	Loans and Participations Sold	Loans and Participations Purchased	Net Loans and Participations Sold	Purchases as a Percent of Sales
1975	$5.2B	$8.5B	($3.3B)	163.5%
1976	8.4B	12.8B	(4.4B)	152.4
1977	13.8B	14.5B	(0.7B)	105.1
1978	15.5B	11.0B	4.5B	71.0
1979	18.3B	12.0B	6.3B	65.6
1980	15.9B	13.0B	2.9B	81.8
1981	12.6B	10.5B	2.1B	83.3
1982	53.4B	23.3B	30.1B	43.6
1983	53.3B	44.2B	9.1B	82.9
1984	59.3B	59.7B	(0.4B)	100.7

Source: Research Department, U.S. League of Savings Institutions
Federal Home Loan Bank Board

National Council of Savings Institutions
Peter E. Knight
Director
Housing and Mortgage Finance

May 29, 1985

The Honorable Slade Gorton
Chairman
Subcommittee on Financial Institutions
and Consumer Affairs
Committee on Banking, Housing, and
Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator Gorton:

On behalf of the National Council of Savings Institutions, I would like to respond to the questions you asked Christopher R. Dunn, Senior Vice President of the Boston Five Cents Savings Bank. I have discussed the questions with Mr. Dunn, and the following responses reflect both his views and those of the National Council.

1. How clearly do you explain the existence of initial discounts to customers when they apply for ARMs? Do you tell them that their rate will go up even if interest rates generally are stable?

The Boston Five feels that the Federal Reserve Board's "Consumer Guide to Adjustable Rate Mortgages" is an excellent publication. All ARM applicants receive a copy of this booklet, which details the effects of discounts on loan structures and possible payment increases.

2. What standards do you use to qualify people for ARMs with initial discounts? Are they more stringent than your normal qualifying standards? Shouldn't they be?

The Boston Five's qualifying standards for ARMs are more stringent in two major respects. First, the underwriting for higher loan-to-value ratio loans is tighter than that for lower loan-to-value loans. Furhtermore, there is less flexibility in the application of loan payment to income ratios for ARMs.

3. How significantly have ARMs contributed to any improvement in the condition of the thrift industry?

While the concept of assets for thrifts that are shorter in duration can only be positive, the actual results of ARM lending for the thrifts are not yet in. Many of the outstanding ARMs are currently adjusting downward which may harm earnings. We will have to wait for

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a cycle of interest rates to be completed before we have other important data. For instance, as fixed rate mortgages drop to 12 percent, we will undoubtedly see homeowners refinancing ARMs in order to lock in lower fixed rates.

However, we should not be surprised that this answer is not clearcut. ARMs are critically important to the thrift industry. However, as with so many other issues affecting the thrift industry, there are no simple answers, and in spite of their importance, ARMs provide no panacea to the thrifts' problems.

4. Have ARM issuers been holding ARMs in their portfolios or have they been selling then off in order to continue issuing new mortgages and earn commitment fees?

Most institutions keep most of their ARM production. The Boston Five has an ARM portfolio of $300 million, some of which were purchased from other lenders.

5. Do ARM issuers adequately consider a borrower's future credit worthiness since his income may remain constant in the face of significant increases in his mortgage costs?

At the Boston Five, great importance is placed on the borrower's future income prospects. The likelihood of increased income is a major factor in our ARM underwriting.

I hope that this letter adequately responds to your questions.

Sincerely,

Peter E. Knight
Director of Mortgage Finance

Senator GORTON. Thank you.

The final panel is Ms. Meier, Mr. Aylward, and Ms. Caplan.

Ms. Meier, I think you are first on the list.

As has been the case with each of the previous panels, we would appreciate your limiting your opening statements to 5 minutes. Your written statements, which we already have, will be included in the record.

STATEMENT OF MICHELLE MEIER, DIRECTOR OF GOVERNMENT RELATIONS, CONSUMERS UNION

Ms. MEIER. Thank you very much, Senator Gorton. I am pleased to be here representing Consumers Union, publisher of Consumer Reports magazine. I am also making the oral statement on behalf of the Consumer Federation of America [CFA].

As you are aware, the ARM issue is a very important issue, which stems from the fact that purchase of a home, the incurring of a mortgage obligation is a very serious matter for an individual consumer, probably the most important financial obligation that any consumer ever gets into.

Simply to summarize up front, Consumers Union and CFA believe there are three main issues to focus on right now.

One, the fact that ARM's need to be standardized to allow easier comparison by consumers for comparison shopping purposes, and to enable the regulators and Congress to devise a full and comprehensive, meaningful disclosure form to allow consumers to comparison shop.

Second, we also believe that rate restrictions, legislatively imposed, are very, very important. I will spend most of my time talking about that.

DISCLOSURES ARE INADEQUATE

Finally, another issue that hasn't been addressed, I think, in this hearing is the fact that disclosures at the present time are inadequate. By that I mean disclosures of what a specific mortgage instrument, ARM, what its terms are.

I am not just talking about generic disclosures provided in handouts, generally describing the nature of an adjustable rate mortgage, but the regulation of the nature and disclosure of the terms in specific ARM's by all the different Federal agencies is woefully lacking at this time.

ARM's have proliferated. We have already heard testimony that within the recent past they constituted 60 percent of all mortgage originations.

Our basic point is that while it may be reasonable for lenders to wish to have some flexibility in the yield they receive on their assets, it is not fair to impose the total rate risk on consumers. A reasonable balance must be achieved.

We believe that the reasonable balance is a 1-percent annual rate cap and 5-percent lifetime rate cap. A 1-percent annual rate cap roughly corresponds, in terms of its effect on annual payment changes, to a 7.5-percent payment cap.

We have chosen this 1-percent rate cap, then, to correspond with the average annual increase in workers' income. This will prevent payment shock, which is one of the most serious, probable problems with adjustable rate mortgages.

Now, it is true, as other witnesses have said today, that our recommendations of rate caps could have the result of foreclosing certain consumers from entering the mortgage market. This could happen because the caps would then move lenders to slightly increase their initial rates on ARM's or to adjust their formulas to make them a little bit more expensive at least initially, although they will still remain below fixed rate costs.

This could then make those who are only marginally qualified for ARM's and foreclosed from the fixed rate market now to be foreclosed from the adjustable rate market. However, it is these consumers who at this time are marginally capable of entering the unregulated ARM mortgage market that should be foreclosed from entering the mortgage market. These are the consumers whose income only allows them to marginally qualify for ARM's under the normal qualification standards, which are based on income of lenders.

Now, it has been mentioned that an ARM can be a good deal for what I would call transient consumers, those consumers who could also afford a fixed rate mortgage at this point but when they shop around they can discover, through careful learning of ARM terms versus fixed rate terms, that they might get a better deal with a discounted ARM if they are only going to be staying in the mortgaged property, for instance, 2 or 3 years.

However, these particular borrowers are not the ones that policymakers should be attempting to protect at this point. These borrowers, as I said, could qualify for a fixed rate loan, and in fact what they are doing is imposing losses on the lenders. It is not these borrowers that the lenders are seeking in trying to resist rate caps and offering ARM's without any rate caps.

So we do not consider the option that would be foreclosed by our rate caps in terms of providing a particularly beneficial mortgage for these transient, small number of consumers a loss. In fact, we would still have mortgages, ARM's, available on the market with fixed rate mortgages, and we would simply be eliminating the gross risks that would be posed to those many, many consumers who are actually being targeted for ARM purchases, those who are marginally capable of qualifying, with no anticipation of greater than an approximately 7.5 percent annual payment increase or income increase.

Since my time is limited, I will simply mention that in my testimony I have attached appendices which show in one instance, what can happen when you have no rate caps and no payment caps. That is appendix No. 1.

Appendix 2 shows the exact same initial figures, but with no rate cap, and a 7.5 payment cap, which then triggers negative amortization.

DRASTIC PAYMENT INCREASES

You will then see that the equity position of the borrower, when you examine these charts, is horrendous in a short amount of time once interest rates go up and the consumer's balance increases dramatically. At that point you also have higher interest rates which, combined with the increasing balance, can produce drastic payment increases, drastic payment shock when the loan is required to be recast or reamortized once the offsetting balance exceeds 125 percent of the initial balance, which is a common point at which reamortization occurs, when negative amortization is allowed.

So I hope you will closely examine those figures to get a better sense, as I hope consumers can through increasing disclosure, of what can happen without caps.

Finally, I will briefly, although I wish I had more time, discuss the disclosure issue at this point. In my testimony I have enumerated those elements of ARM features which are terribly important to be disclosed to the consumer before the consumer submits his loan application to the lender. I won't go into them all right now.

The most important one, or one of the most important ones, is the hypothetical disclosure of an amortization schedule showing the payment increases and the outstanding balance increases or decreases that could occur over time with the particular adjustable rate mortgage being offered by the lender.

At this point that disclosure is woefully, woefully misleading and inadequate in terms of how it is specified by the Federal regulators. The Comptroller of the Currency has the best regulation on this particular subject, and it requires a disclosure of a hypothetical rise in index rate of 2 percent a year for 5 years.

Now, obviously, this kind of disclosure does not allow the consumer to distinguish a 2-percent rate capped ARM from a capless ARM. Therefore, a lender offering a capless ARM is going to appear as if he were offering a loan as good as the next loan that is capped.

Further, the Comptroller's regulation, as is true of all the other regulators, does not even require disclosure of the effects on the outstanding balance of negative amortization. There is no balance disclosure requirement.

As my testimony and the graphs at the end will indicate to you, the effects of negative amortization can be devastating to a consumer. Especially since in many regions of the country only 7.5 percent payment caps are being used, negative amortization can occur, and this outstanding balance disclosure must be required.

The timing of this disclosure is terribly important, also. Only the Comptroller's regulation requires a disclosure before the borrower submits his loan application. A tremendous psychological commitment, in addition to a $200 or $250, on the average, financial commitment, is involved when a borrower submits a loan application, creating a strong tug against—unless disclosures are made—against shopping around and going to another lender.

We urge Congress to require that a full disclosure be made, showing a true worst case scenario, and that this disclosure be made at an appropriate time before the borrower submits his loan application.

Thank you very much.

[The complete prepared statement follows:]

STATEMENT OF

MICHELLE MEIER, COUNSEL FOR GOVERNMENT AFFAIRS
CONSUMERS UNION

AND

ALAN FOX, LEGISLATIVE REPRESENTATIVE
CONSUMER FEDERATION OF AMERICA

PRESENTED BY

MICHELLE MEIER

ON

ADJUSTABLE RATE MORTGAGES

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER AFFAIRS AND
SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

OF THE

SENATE COMMITTEE ON BANKING, HOUSING AND
URBAN AFFAIRS

APRIL 19, 1985

Consumers Union of U.S., Inc.* and Consumer Federation of America,** (CFA) appreciate the opportunity to testify today on adjustable rate mortgages (ARMs). We believe that legislation restricting and standardizing the features of ARMs and requiring the full and timely disclosure by lenders of ARM terms is immediately necessary. Hopefully, these hearings will lead to the development of such legislation.

INTRODUCTION

With the volatility of market interest rates, lenders have demanded flexibility in the rate of return they receive on their assets. In the case of mortgage loans, this flexibility takes the form of an ARM.

While Consumers Union and CFA recognize that the ARM is an unavoidable fact of life in the present world of volatile interest rates, we also believe that the consumer should not be made to bear all or even most of the risk of interest rate fluctuations. The consumer is a relatively fragile financial unit that is generally not equipped to assess risk or to withstand sharp expense increases. High rates of foreclosure and/or high numbers of consumers painfully overextended in making payment on their mortgages are the costs of the present policy in which lenders are free to shift all or most of interest rate risk to borrowers.

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*Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the State of New York to provide information, education, and counsel about consumer goods and services and the management of the family income. Consumers Union's income is derived solely from the sale of Consumer Reports, its other publications, and films. Expenses of occasional public service efforts may be met, in part, by nonrestrictive, noncommercial grants and fees. In addition to reports on Consumers Union's own product testing, Consumer Reports, with approximately 3 million circulation, regularly carries articles on health, product safety, marketplace economics, and legislative, judicial, and regulatory action which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

**Consumer Federation of America is a coalition of over 200 national, state and local consumer, senior citizen, labor, farm, cooperative and rural organizations which together represent more than 30 million people.

The better alternative is to balance fairly the protection of both lenders and borrowers by allowing the sale of ARMs but by setting substantive limits on their risk-related terms. Lenders can adjust to the restrictions by varying their ARM rate formulas or initial rates to obtain the return they need. To the extent this results in disqualifying certain consumers that otherwise would qualify for an ARM, one can only rejoice. In such a case, most of the disqualified consumers should never qualify and only would because the interest rate risk, which they might unknowingly or recklessly accept, is put entirely on their shoulders.

A. ARMS UNDER THE MICROSCOPE

1. There Is No Standardization.

The types of ARMs on the market today are too numerable to quantify. For example, some ARM rates adjust according to a formula based on an index and a margin. Others adjust according to an index alone on the basis of either absolute or percentage variations in its movement.

Further, many different indices are used, including the movements of Treasury securities, the cost of funds to thrift institutions, and the average return on fixed rate mortgages. Not only must the consumer compare among many different indices, which can be mind-boggling in itself, but he must also compare between the varying uses lenders make of the index values. Some lenders adjust mortgage rates on the basis of a single index value at a certain point in time. Others establish the mortgage rate by averaging the index values over an extended period.

Even if disclosures were comprehensive, these and other variations among ARM features make it extremely difficult for consumers to comparison shop for a mortgage. Consequently, Consumers Union and CFA recommend legislation to standardize the basic elements used to derive the accrual interest rate* of all ARMs. Under the legislation, all ARMs would adjust on the basis of one or two selected indices, and all accrual rates would be calculated, for example, by an index-plus-margin formula on the basis of the index values averaged over time.

This suggested legislation will go far not only in making comparison shopping possible, but in allowing both Congress and the regulators to devise a meaningful disclosure requirement that covers all ARMs. It is difficult to prescribe full and useful disclosures when the crucial elements to disclose, particularly the factors used to determine accrual rates, vary in so many ways.

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*The accrual interest rate is the rate actually applied to the mortgage balance at any point in time to determine the interest due. Where an index-plus-margin formula is used, the accrual rate is the sum of the index value and margin at any point in time.

Our proposed legislation will not, however, interfere with the market's ability to price the ARM as costs and competition dictate. Rather, like unit pricing, it will merely standardize the measures of price so that comparisons are possible.

2. Mandatory Rate Caps Are Required.

Consumers Union and CFA believe that legislatively required rate caps, both annual and lifetime, are necessary to shield consumers from unreasonable risk. We recommend a required 1% annual cap and a 5% lifetime cap.

The 1 Percent Annual Rate Cap

In terms of its effect on payment adjustments, at least in the early years of the loan, a 1% annual rate cap roughly corresponds to a 7.5% annual payment cap, which is popular on the market today. This popularity is probably based on the fact that a higher annual payment increase is beyond the means of most consumers to whom the ARM has been especially targeted, i.e., those that can not initially qualify for a fixed rate loan but can "afford" an ARM because of anticipated future income increases. For reasons that we discuss below, however, a 7.5% annual payment cap, without a 1% rate cap, is a grossly inadequate, and potentially deceptive, protection for borrowers.

During the years 1974 through the end of 1983, the average hourly earnings of the private nonfarm sector rose at a yearly average of 7.3 percent in constant dollars.* Consequently, in today's environment of inflated housing prices and rates, in which the average consumer, if he is lucky, must severely budget his resources to afford even a moderately priced and financed home, annual payment increases that exceed the average increase in earnings will cause severe financial hardship for many.

As the mortgage industry continually asserts, many consumers that can qualify for an ARM cannot qualify for a fixed-rate loan. This implies that these consumers, when they initially enter into an ARM agreement, are marginally able to meet the maximum income-to-payment ratio required to qualify for the loan.

Any percentage increase in payment beyond such a borrower's percentage increase in earnings brings his income-to-payment ratio beyond the maximum normally allowed for qualification. In such a situation, the risk of default is high. Short of default, such a percentage payment increase will impose serious financial hardship on the borrower.

Consequently, we recommend an annual rate cap of 1% to prevent rate-determined payment increases greater than a figure roughly equivalent to the average annual increase in worker's earnings. Although we recognize that some consumers with large incomes can afford higher yearly increases, the risk to the many consumers who cannot is too great to justify the introduction of mortgages that permit higher payment increases.

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*Source: Bureau of Labor Statistics, U.S. Dept. of Labor, Current Wage Developments (Feb. 1985) (page 26).

We believe we cannot stress too much the fact that ARMs are being "sold" to the Congress, the regulators and other policymakers as a way to bring into the market consumers who otherwise would be disqualified from homeownership. They should conform to that purpose by containing annual rate caps that only allow rate-based payment increases comparable to the average increase in earnings of those for whom the ARM is purportedly designed.

With our suggested annual rate cap, some borrowers now unable to qualify for a fixed-rate loan might also be unable to qualify for an ARM because the ARM's initial rate will probably be set a bit higher to compensate for the caps. However, some of these disqualified borrowers can still safely enter the housing market with a graduated payment mortgage if they have a definite assurance of future income increases. Those totally foreclosed from the mortgage market because of our added protections should never have qualified for a mortgage to begin with.

We make these recommendations also fully aware that they will reduce the many mind-boggling options of those consumers who are now capable of qualifying for either a fixed-rate loan or an ARM. However, in most cases, the value of those options is illusory, and certainly no better than an ARM incorporating our recommendations.

We concede that our recommendations will probably foreclose one option that might produce an advantage for one small class of consumers. This is the discounted ARM with annual rate caps, which, according to industry claims, can be less expensive than a fixed-rate loan if the borrower only plans to stay in the mortgaged property for two or three years.

However, these are not the borrowers that lenders want in offering ARMs because the discounted initial rates result in little profit during the loan's short life. Thus, from the industry's perspective, the elimination of this cheaper option for this small class of borrowers is no loss.

From a policy perspective, to eliminate this option for this small class of consumers in favor of risk protections for the majority of consumers is the preferred choice. In fact, it is this class of "transient consumers" that require lenders to impose high rates and rate risks on the majority of ARM borrowers to compensate for the losses they incur through the early prepayment.

In sum, our recommendations could cause an upward shift in initial ARM rates. This could foreclose some consumers from the housing market who should not be there in the first place. Other consumers will have less opportunity to take a bad gamble that they can more easily afford than most. At least as far as mortgages to finance the borrower's residence are concerned, we should not allow the home finance industry to become a high risks game in which only the wealthy can afford to lose.

The Total Inadequacy of a Payment Cap.

Only a yearly rate cap is a solution to the payment shock that can accompany rate-determined payment increases. The "alternative" is a payment cap allowing an annual percentage payment increase that is comparable to the maximum percentage payment increase produced by a 1% rate cap, i.e., an annual percentage payment increase cap of approximately 7.5%. This option, however, creates the serious problem of negative amortization.

The mortgage industry euphemistically characterizes negative amortization as a "cushion" to protect the borrower against interest rate increases. This characterization is terribly misleading except where the potential rate increases are strictly limited, the value of the mortgaged property is definitely on the rise, and the borrower is definitely able to handle the higher payments resulting from the increasing rates and balance amounts.

Appendix I exemplifies the problems created by negative amortization. There, the payment figures reflect an annual

7.5% payment cap. The accrued rates are based solely on a hypothetical index rate value plus a 3 percent margin, with no interest rate cap. The hypothetical index rate contains values comparable to the Treasury securities indices that are popular today, i.e., values of 12, 15, 16, 15, 12, and 15 from years 2 through 7, respectively. (The first year's rate is discounted.)

In spite of the relatively moderate fluctuations in the index rates, the borrower's balance on the loan reaches $82,929 by year 7. This is a whopping $17,928 increase from the original balance of $65,000.

Much has been said about the "disciplining" effect of the secondary mortgage market and the mortgage insurance industry as a justification for the lack of regulatory restrictions on ARMs. Let us assume, then, that Fannie Mae's recommended reamortization standard* applies to the loan represented in Appendix I, requiring the loan to be recast when the outstanding balance equals 125% of the original loan amount. Since 125% of the original loan amount in our example ($65,000) equals $81,250, this Fannie Mae standard would require the loan to be recast at some point during year 7. With the accrual rate on the loan at 18% at that time, the required monthly payments resulting from the reamortization will total

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*As far as we are aware at this time, Fannie Mae has not adopted this standard as a requirement for ARMs it purchases. However, it has endorsed the standard, which has been adopted by MGIC. See testimony of David O. Maxwell, Chairman and Chief Executive Officer, Federal National Mortgage Association, before the Subcommittee on Housing and Community Development, Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, Aug., 1, 1984.

$1,237.33. This is a 39% increase above the payments required in year 6. Not many consumers could withstand this type of payment shock.

The equity position of the borrower at this point does nothing to improve his dilemma. If he attempts to sell his property to get out from under the payment strain, he faces a very formidable interest rate environment that could make a sale impossible. More significantly, it is very possible at this point that the mortgaged property, even after 7 years of increasing payments, is worth less than the borrower's outstanding balance.

Many housing analysts have forecast that property values will not appreciate, or will only minimally appreciate, in the coming years. Yet, assuming the initial loan balance reflects the original value of the mortgaged property in our example, the property would have to appreciate approximately 3.75% each year between years 1 and 7 just for the borrower to be able to pay off his loan with the proceeds from the sale of his home.

The 5 Percent Lifetime Cap

Our recommendation of a 5% limit on rate increases over the life of the ARM is mainly based on our belief that consumers should not be forced to accept the entire interest rate risk of a mortgage. To permit the lender an overall rate adjustment range of five percentage points allows sufficient and fair flexibility to respond to fluctuations in market interest rates.

Certainly, it is possible that future market rates could stick at a point higher than 5 percentage points above today's rates. However, compared to the borrower, the lender, which deals in volume and is allowed to diversify its assets, is in a much better position to absorb whatever losses might ensue. As a practical matter, an institutional solution, such as the present net worth certificate program, to the economic difficulties this scenario would create would be more efficient than dealing with millions of individual foreclosures and bankruptcies.

An example of what can happen to a borrower's payment without either an annual or lifetime rate cap is illustrated in Appendix II, which represents a baseline ARM with features identical to the ARM represented in Appendix I but having no payment cap. There, the third year payment, reflecting a fully amortizing rate of 18%, is $975.07, up $356, or 58% percent, from the original payment amount of $619.01. In year four, the fully amortizing rate is 19%, bringing the payment to $1027.29, or 66% higher than the initial payment amount. This is an obvious example of payment shock.

Negative amortization can grossly aggravate the effect of unlimited rate increases, as is illustrated in Appendix I. There, the early accrual rate increases produce rapid increases in the principal balance. The high principle balance increases combine with increases in the interest rate to continue the negative amortization spiral. Only a significant later break in interest rate increases beginning in year 10 allows the borrower to begin chipping away at his outstanding balance, which by then has skyrocketed to $85,969, from an original $65,000.

In sum, unlimited rate increases can cause severe payment shock early in the life of the mortgage. Combined with negative amortization, it can cause a spiral in which increasing rates combine with an increasing balance to produce additional negative amortization. At least in the case of a mortgage on the borrower's primary residence, these potentially devasting results should be strictly forbidden by a mandated 5% lifetime rate cap.

3. The Market Is Subjecting Consumers To Excessive Risk.

A study by the U.S. League of Savings Institutions* was widely touted last summer as evidence of the current "profusion" of consumer safeguards in ARMs. Consumers Union and CFA find the survey results to be a far cry from reassuring in terms of the reasonableness of the risk that consumers are being asked to bear.

It is only fair to assume that survey results prepared by the U.S. League are presented in a light most favorable to the industry. Yet, using deductive analysis, we find that even these results, some of which are listed below, show that a startling high percentage of ARMs currently in the marketplace have no caps that we consider adequate.

% without 5% (or less) Lifetime Rate Cap: 15.5%
% without 1% (or less) Annual Rate Cap: 88.1%
% without 2% (or less) Annual Rate Cap: 49.3%

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*U.S. League of Savings Institutions, "ARMs: A Study of Adjustable Rate Mortgages Being Made at Savings Institutions." (1984).

Obviously, the industry is not policing itself sufficiently. Few ARMs have satisfactory annual rate caps, and, though significantly less, a substantial number of ARMs are without a 5% lifetime cap.

On the other hand, the large number of ARMs with a 5% lifetime rate cap, and the not insignificant number of ARMs with an annual rate cap, provide evidence that these rate restrictions do not impose intolerable burdens on the ARMs profitability.

B. DISCLOSURE REQUIREMENTS

1. The Limits Of Disclosure

Consumers Union and CFA do not believe that full disclosure of terms, even assuming that were obtainable, will solve all the risk-related problems posed by unregulated ARMs. For full disclosure to be effective in preventing consumers from over-exposing themselves to risk, several other phenomena must be in operation.

First, the consumer must understand the disclosures. ARMs, with their complicated payment structures and rate adjustment formulations, are difficult for even the most sophisticated consumers to understand.

Second, the consumer must appreciate the risks involved. Few economists, much less the average consumer, are capable of predicting the future course of interest rates. Consequently, although a consumer may realize, through a disclosure, that his mortgage accrual rate could hit 20%, he lacks the ability to predict the likelihood of that possibility. Further, although he knows that a payment cap might cause an increase in his balance amount, he would probably find it difficult to figure out that rapid early rises in the mortgage rate could quickly cause his outstanding balance to skyrocket beyond his equity interest in the property. He is not equipped to assess accurately the potential for his property to appreciate. Nor is he likely to understand fully the payment shock that could occur if the increase in the outstanding balance requires the loan to be recast.

Commonly encountered psychological factors also work against the consumer's cold and rational appreciation of even the fullest disclosures. These factors include the very American wish to become a homeowner, and the very human tendency to overlook certain risks to achieve a dream. Also at work is the not infrequent habit of lenders to understate the risks of a loan. Even if a realistic worst case rate and payment schedule were disclosed in connection with a capless ARM, it is most reasonable to assume that many lenders, with a pat on the applicant's back, would assure the consumer that, "of course, you're never going to see rates go way up there."

Given these limits on the effectiveness of disclosure to prevent unreasonable risk-taking by borrowers, and the huge investment that a mortgage represents for consumers, we urge the substantive rate caps discussed earlier. This is not to say, however, that disclosures are useless. Rather, once the most abusive ARMs are eliminated through statutory rate restrictions, consumers still vitally need full and complete disclosures to assess and compare the not insubstantial risks and costs of the ARMs that will remain in the market.

If no rate caps are required by law, then full disclosures are even more urgent. Indeed, even those who represent the mortgage industry defend their opposition to regulatory restraints on the ground that grossly over-reaching ARM terms will be eliminated if disclosures present the full risk to the potential borrower. While we believe that disclosures can never communicate the full risks of capless ARMs to the many consumers who are unable to comprehend and appreciate them, it is a basic step in protecting those who possess that capability.

2. The Essential Disclosures And Their Timing.

The following disclosures, at a minimum, are essential:

1. A general explanation of the nature of an ARM, including:
   - a. that rates may change
   - b. how changes are calculated
   - c. carryover requirements
   - d. payment caps and negative amortization
   - e. recasting requirements

2. Specific disclosures revealing the terms of the specific ARM offered by the lender, including:
   a. the initial rate (if this is unknown, that fact must be stated, and the lender must then reveal the method by which the initial rate will calculated.)
   b. method by which rate adjustments will be calculated, including:
      i. identification of the interest-rate index, its source of publication and availability, including a 10-year historical series of the index.
      ii. identification of the margin or any alternative method to be used to arrive at rate adjustment values.
      iii. rate caps and carryover provisions (if there are not caps, this must be prominently disclosed.)
   c. payment caps, including a prominent statement as to whether negative amortization is possible, and any limits thereon. If negative amortization is possible, but limited, the effect of reaching the limits (e.g., THE FACT THAT THE LOAN WILL BE RECAST AND PAYMENT CAPS

WILL BE REMOVED, BUT THAT INTEREST RATE ADJUSTMENTS WILL CONTINUE). (Any such recasting requirements and effects should be prominently disclosed.)

d. an hypothetical amortization schedule showing the maximum increases in monthly payments and outstanding balance during the first 10 years of the mortgage, subject to the provisions of the mortgage instrument. (This crucial item is discussed more fully below.)

e. an itemization of all fees, if any, that will be charged in connection with the loan.

f. the initial loan term.

g. prepayment penalties, if any.

h. due-on-sale requirements.

i. assumability conditions.

These disclosures must be available to a prospective borrower at the time he begins to shop for a loan. To delay the disclosure almost totally defeats its purpose, which is to allow the consumer to learn all the significant variations among available ARMs so that he can apply for the most advantageous one.

Disclosure at the time of, or after, application is of little value. Obviously, after the consumer has paid a not insubstantial application fee of $200-250, and invested time and effort in responding to the lender's inquiries into his credit background, a large psychological commitment to "sticking it out" with that lender develops. Consequently, if later disclosures reveal that the specifics of the loan for which he has applied are not good, it will be extremely difficult, financially and psychologically, to move to another lender. The incentive to find another lender will be particularly low in light of the fact that delayed disclosure of unfavorable terms in the second lender's ARM could also occur.

The timing of the precontract disclosures required under both the Truth-in-Lending Act regulations and the FHLBB regulations are wholly inadequate. Both require disclosure within three days following receipt of the loan application. (12 C.F.R. section 226.19(a)(FRB); 12 C.F.R. section 545.33 (FHLBB)). On the other hand, the Comptroller requires disclosure at the time the lender provides a loan application form to the potential borrower. (12 C.F.R. section 29.7)

We urge you to direct all the agencies to require timely disclosures before the consumer makes the financial and psychological commitment to "go" with any particular lender.

3. The Worst Case Hypothetical.

A crucial disclosure is the hypothetical amortization schedule showing the maximum potential increases in monthly payments and outstanding balance during the first 10 years of the specific mortgage. The majority of consumers will not fully comprehend the dollars and cents effects of their disclosed ARM terms unless an amortization schedule showing potential rate, payment and outstanding balance adjustments is provided.

A "worst case" disclosure poses problems in a regulatory environment in which anything goes. Without annual and lifetime rate caps, a "worst case" scenario could mean unlimited rate increases, potentially exceeding 100%, which is clearly unrealistic and therefore meaningless. A significant benefit of our suggested annual and lifetime caps is that they will allow the full and accurate disclosure of a worst case scenario. The worst case in that circumstance would be a 1% rate rise each year for 5 years, with the rate stuck at the maximum 5% increase after the fifth adjustment.

Absent legally-imposed rate restrictions, a worst case scenario should be just that--a disclosure showing dramatic rate rises in the early years of the mortgage. At this time, the Comptroller's regulation requiring a hypothetical payment schedule disclosure is the most strict among all the agencies' regulations on this subject. However, even the Comptroller only requires the lender to disclose future payments based on hypothetical index rate increases of 2% per year for the first five years of the loan and a constant interest rate index thereafter. 12 C.F.R. section 29.7(a)(11). Obviously, this requirement will not produce disclosures that distinguish between the effects of a capless loan and a loan with a 2% annual and 5% lifetime rate cap.

Additionally, none of the regulators require that the hypothetical amortization schedule disclosure reveal the effect of rate adjustments on the outstanding balance. This is a fatal flaw, particularly since negative amortization is one of the most difficult concepts for consumers to understand and appreciate.

In sum, although most people concede that an hypothetical worst case amortization schedule disclosure is vital, the agencies have been extremely lax in prescribing one. The Federal Reserve Board staff has been candid in stating that lenders oppose such a disclosure because it will have a negative effect on the marketability of ARMs. Consequently, in light of the undue influence the industry appears to have on the regulators, we urge you to enact into law a worst case scenario disclosure requirement. It is a basic prerequisite for consumers to make informed choices regarding ARMs.

		Int	--Monthly Payments--			--Paid to Date--			Outst
Yr	Mo	Rate	Total	Intrst	Prncpl	Total	Intrst	Prncpl	Bal
1	12	11.00	619.01	593.39	25.62	7428	7136	293	64707
2	24	15.00	665.44	829.84	-164.41	15413	16965	-1552	66552
3	36	18.00	715.34	1048.62	-333.28	23997	29239	-5241	70241
4	48	19.00	768.99	1176.89	-407.89	33225	42963	-9738	74738
5	60	18.00	826.67	1173.45	-346.78	43145	56722	-13577	78577
6	72	15.00	888.67	995.91	-107.24	53809	68589	-14780	79780
7	84	18.00	955.32	1239.65	-284.33	65273	83201	-17928	82928
8	96	16.00	1026.97	1118.05	-91.08	77597	96542	-18945	83945
9	108	18.00	1103.99	1286.79	-182.80	90845	111814	-20969	83969
10	120	15.00	1123.71	1067.42	56.29	104329	124667	-20337	85337
11	132	16.00	1187.26	1130.08	57.18	118576	138275	-19699	84699
12	144	17.00	1250.50	1191.43	59.07	133582	152624	-19042	84042
13	156	17.00	1250.50	1180.57	69.93	148588	166853	-18264	83264
14	168	17.00	1250.50	1167.71	82.79	163594	180938	-17344	82344
15	180	16.00	1191.60	1083.22	108.38	177894	194027	-16133	81133
16	192	16.00	1191.60	1064.55	127.06	192193	206907	-14714	79714
17	204	17.00	1246.60	1109.65	136.95	207152	220343	-13191	78191
18	216	17.00	1246.60	1084.47	162.13	222111	233500	-11389	76388
19	228	17.00	1246.60	1054.65	191.95	237070	246325	-9254	74254
20	240	17.00	1246.60	1019.35	227.24	252030	258757	-6727	71727
21	252	17.00	1246.60	977.57	269.03	266989	270725	-3736	68736
22	264	17.00	1246.60	928.09	318.51	281948	282142	-194	65194
23	276	16.00	1207.97	816.13	391.84	296444	292261	4182	60818
24	288	15.00	1173.58	699.69	473.88	310526	301028	9498	55502
25	300	17.00	1234.69	711.23	523.46	325343	310024	15319	49681
26	312	18.00	1261.57	653.33	608.24	340482	318429	22053	42947
27	324	19.00	1284.12	566.04	718.08	355891	325923	29968	35032
28	336	21.00	1319.82	464.45	855.37	371729	332414	39315	25685
29	348	18.00	1282.28	225.65	1056.64	387116	336103	51013	13986
30	360	20.00	1295.63	21.24	1274.39	402664	337664	65000	-0

APPENDIX I (Starting balance - $65,000;
No rate caps;
7.5% payment cap.)

		Int	--Monthly Payments--			--Paid to Date--			Outs
Yr	Mo	Rate	Total	Intrst	Prncpl	Total	Intrst	Prncpl	Bal
1	12	11.00	619.01	593.39	25.62	7428	7136	293	64707
2	24	15.00	819.71	807.25	12.46	17265	16332	432	64568
3	36	18.00	975.07	967.35	7.72	28965	28448	518	64482
4	48	19.00	1027.29	1019.77	7.52	41293	40692	601	64399
5	60	18.00	975.36	964.32	11.04	52997	52274	723	64277
6	72	15.00	823.28	800.56	22.72	62877	61899	978	64022
7	84	18.00	973.71	957.95	15.75	74561	73409	1152	63848
8	96	16.00	873.89	847.76	26.13	85048	83604	1444	63556
9	108	18.00	972.43	949.94	22.49	96717	95024	1693	63307
10	120	15.00	827.50	786.04	41.45	106647	104489	2158	62842
11	132	16.00	874.29	832.18	42.11	117138	114510	2628	62372
12	144	17.00	920.86	877.36	43.50	128189	125077	3112	61888
13	156	17.00	920.86	869.36	51.50	139239	135555	3685	61315
14	168	17.00	920.86	859.89	60.97	150289	145927	4362	60637
15	180	16.00	877.49	797.68	79.81	160819	155565	5254	59746
16	192	16.00	877.49	783.93	93.56	171349	165050	6299	58701
17	204	17.00	917.99	817.14	100.85	182365	174945	7420	57580
18	216	17.00	917.99	798.60	119.39	193381	184633	8748	56252
19	228	17.00	917.99	776.64	141.35	204397	194077	10320	54680
20	240	17.00	917.99	750.65	167.34	215413	203232	12180	52820
21	252	17.00	917.99	719.87	198.11	226429	212045	14383	50617
22	264	17.00	917.99	683.44	234.55	237444	220453	16991	48008
23	276	16.00	889.54	600.99	288.55	248119	227905	20214	44786
24	288	15.00	864.22	515.25	348.97	258489	234361	24129	40871
25	300	17.00	909.22	523.75	385.48	269400	240985	28415	36585
26	312	18.00	929.01	481.11	447.91	280548	247174	33374	31626
27	324	19.00	945.62	416.83	528.79	291896	252693	39203	25797
28	336	21.00	971.91	342.02	629.89	303559	257473	46086	18914
29	348	18.00	944.27	166.16	778.10	314890	260190	54700	10300
30	360	20.00	954.10	15.64	938.45	326339	261339	65000	-0

APPENDIX II (Starting balance - $65,000;
No rate caps;
No payment cap.)

Senator GORTON. Mr. Aylward.

STATEMENT OF JAMES F. AYLWARD, TREASURER, MORTGAGE INSURANCE COMPANIES OF AMERICA

Mr. AYLWARD. Mr. Chairman, my name is James F. Aylward, president and chief executive officer of Investors Mortgage Insurance Co. in Boston, one of the 13 private mortgage insurance companies.

I am presenting this testimony as an officer of the Mortgage Insurance Companies of America [MICA].

My background includes over 25 years of mortgage lending, 12 years of which I was the president of a mortgage banking firm headquarters in Senator Slade Gorton's State of Washington.

In addition to this, I have several professional designations that give credibility to my testimony. I am an MAI, a member of the American Institute of Real Estate Appraisers, and SRPA, a member of the Society of Real Estate Appraisers, a certified mortgage banker, and I was president of the Mortgage Bankers Association of America in 1982.

Before discussing the issues surrounding ARM's, it is appropriate to reiterate a previous discussion, Senator, regarding the Federal deficits. Continuing deficits in the Federal budget will result in high and volatile interest rates and the need for ARM's.

Today's home buyer has to compete with the Federal Government for credit. The concept of adjustable rate mortgages was based first on inflation continuing in housing values—we have actually seen deflation in housing in the last several years—and, second, that we would have lower interest rates—while rates have lowered some, they are much too high in relation to the low-inflation rates we are now experiencing.

MICA believes today's consumer deserves an opportunity to understand the consequences of the various financing instruments available.

NEED FOR CONFORMITY

We do not seek regulation. We implore leaders in the industry, such as Fannie Mae and Freddie Mac, to reduce the excessive variety of instruments. To understand their complexity requires a graduate degree in finance and creates an environment where uniformed consumers may be abused by excessive buydowns and subsequent payment shock.

The Truth in Lending Act regulation that was adopted in 1970 needs to be updated. We question whether there is truth in what consumers receive, with today's inadequate disclosures.

Although many of the lending problems have gone away, as you have heard in other testimony, there are still many problems out there in the market, and we believe that all consumers deserve better information on mortgage options.

Improved disclosure is needed due to the increased complexity of the total financing package. That includes appraisals, financing terms, buydowns, et cetera. An appraisal should give the consumer some idea how special financing terms affect the price he is paying.

I would like to read from a recent Appraisal Review Journal:

Our experience indicates that there is a direct relationship between poor quality loans and poor quality appraisal. The examination of loan packages that are in default reveals 29 of 30 properties were overappraised and many substantially. Further, a large sample of loan appraisals from properties that are not in default reveal 98 percent of the appraisers listed sales price as the market value. If sales price were the market value, the lender doesn't need an appraiser because he already knows the sales price.

My own company, Investors Mortgage Insurance, has insured over 400,000 loans. I asked for reports of appraisal abuses and found the vast majority of the abuses are caused by people who approach appraising as merely filling out forms. These people have little real appraisal experience and are not designated by any recognized appraisal society.

We call them in our industry form filler-outers, not appraisers, and we implore Fannie Mae and Freddie Mac to improve the form that they now have to require greater information as to the comparables being used and as to the financing and the effect of the financing that has to do with the value, and we ask Fannie Mae to reinstate the approved appraisal list.

They had an approved appraisal list many years ago. That was dropped, and we believe because of Fannie Mae's tremendous influence on the market it is a necessity for self-regulation. It would be in their best interest.

The dichotomy in the discussion of appraisals in home mortgage activities comes from the fact that lenders charge from $1,000 to $2,000 in an origination fee. We insurers charge 800 to $1,200 as an insurance premium, but we expect an appraiser to tell us if we are making a good decision for $125. The value of the appraisal requires an adequate job and the appraiser should get an adequate fee.

HIGH LIQUIDATION COSTS

Fraudulent appraisers not only have hurt consumers and investors but have led to the greatest liquidation cost ever in FSLIC's 50 years' of experience. There is adequate evidence to show that some S&L's have failed because of poor appraisals. It is time to recognize that better appraisals may cost more money. We should be willing to pay. The consumer will know what his home is worth, the lender would have better protection, and the investor would benefit.

Another area is the financing terms. We have found many of our problems were the result of weak, oversold markets for both the seller and the lender who together stretched the financing to unload the project using excessive buydowns, no down payment schemes, furniture packages, and other giveaways such as zero coupon bonds and a car in the garage. Excessive buydowns and financing that appear significantly out of line with market rates can have dire consequences for consumers.

It is true over the years that the industry has recognized a 3- to 5-percent discount on FHA and VA loans. We don't consider that excessive. $10,000 or $15,000 buydowns are certainly excessive and inflate the value of the property.

Builders have used the buyer beware concept. We don't believe it's appropriate for consumers in today's market. The fact is that the buyer pays for buydowns in inflated sales prices.

There is great evidence that substantiates this is a problem for consumers and investors alike. A report by Kerry D. Vandell, an associate professor of real estate for Southern Methodist University concluded:

> The chief culprit associated with Fannie Mae's high foreclosures appears to be buydowns and discounts on fixed rate loans. The latest round of defaults suggests that buydowns with ARM's will pose future risk problems, particularly in a rapidly rising interest rate climate.

Then right in the U.S. League's own publications, the Savings Institutions, March 1985, Dennis Jacobe, the director of research says, "The problem of buydowns is their great cost relative to the total house price." He gives an example of a $100,000 home where the price was increased $28,000 by a buydown.

Senator GORTON. Mr. Aylward, we're well over your 5 minutes; if you'll summarize?

Mr. AYLWARD. In summary, we'd like to say that ARM's can be very helpful for borrowers but too much time has been spent on instrument design and not enough time with the borrower understanding.

The servicing after a loan has been made is important especially as problems develop from the creative financing techniques.

We appreciate your reading our testimony and we'll be happy to answer any questions.

[The complete prepared statement follows:]

STATEMENT OF JAMES F. AYLWARD REPRESENTING THE MORTGAGE INSURANCE COMPANIES OF AMERICA BEFORE THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER AFFAIRS AND THE SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS OF THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS IN REGARD TO ADJUSTABLE RATE MORTGAGES

April 19, 1985

Mr. Chairman and Members of the Subcommittees: I am James F. Aylward, President and Chief Executive Officer of Investors Mortgage Insurance Company of Boston, Massachusetts, one of the thirteen domestic private mortgage insurance companies (MICs) operating in the national housing market. All mortgage insurers are members of the Mortgage Insurance Companies of America (MICA) and I am presenting this statement as an officer and member of MICA's Executive Committee.

This statement will cover three areas of particular interest that have been outlined for the purpose of these hearings. First, I will discuss today's mortgage finance system pointing out certain trends and other developments that are of consequence to the consumer. Second, I will present some views of the association regarding the design and structure of adjustable loans including the need to focus upon improved borrower disclosure. Finally, I will address the adjustable loans within the context of the capital markets.

I would like to say at the outset that many of the problems facing housing and mortgage finance are a byproduct of our Federal deficit. If the Federal government had not continued to pile deficit spending on top of deficit spending, the capital markets today would show greater stability and investors would be less concerned with possible interest rate volatility and the effects of inflation. This has a direct and significant impact upon the cost and availability of housing credit. Although mortgages with adjustable rates have been an effective response to stimulate affordability during the most recent recession, if something is not done to correct our deficit problem, new mortgage finance techniques will be of little help to the American homebuyer.

This hearing concerning modern home financing and the consumer is appropriate due to the major changes that have been occurring in the last several years. For one, the level of complexity involved in the mortgage transaction has increased tremendously. Mortgage instruments now have a myriad of design features. Adjustable payments and rates, negative amortization, buydowns, prepayment penalties, assumability and rate caps are examples. A prospective borrower almost needs a graduate degree in finance just to understand how the instruments work. MICA believes today's consumer deserves an improved opportunity to understand his financing options. Accordingly, later in this testimony I will make some recommendations on this point.

Another aspect of complexity in mortgage finance relates to the operations of the institutions making mortgage loans. Ten years ago the primary originators of mortgages were lenders who kept the loans they originated in their own portfolios. Because making a bad loan hurt the lender directly, mortgage lending was fairly conservative from a risk perspective. Coinsurance, one of the major elements of mortgage insurance wherein the risk of default is shared by the insurance company and the loan originator, was alive and well.

Today this principle has diminished in the eyes of many lenders. It is becoming common for lenders to say that they will make a loan if mortgage insurance companies (MICs) will insure it and the loan can be sold in the secondary market. Investors in mortgages are looking to the MICs for quality control and are transforming the roles of MICs from that of a review underwriter to that of a primary underwriter.

This most disturbing trend was highlighted in an article in the January 1985 edition of Savings Institutions in which the Director of Research of the U.S. League of Savings Institutions, stated:

> "Neither the builder, real estate broker, mortgage banker nor securities firm has a major stake in the quality of the mortgage loan assets sold in today's secondary market. The primary interest of each of these parties is in closing the deal for the sale of the house and doing so in the greatest possible volume. This pressure for maximum volume stands in direct conflict with the basic underwriting goal of quality.
>
> Those who do have a major interest in loan quality in the secondary market are the federal credit agencies and the private mortgage insurers. It is the existence of federal guarantees and private mortgage insurance that relieve Wall Street and mortgage securities investors of asset quality concerns."

Complex financial transactions can be a breeding ground for fraud and misrepresentation. In the last two years, the members of MICA have had to suffer the consequences from more incidents of mortgage lending fraud than at any other time in their history. This affects investors who are providing capital to housing, as well as consumers. Situations in residential lending where major problems have been apparent include:

* Unsound Financing Terms - Borrowers are given loans with interest rates substantially lower than prevailing market rates but which are predicated upon discount points or special financing concessions not related to the true cost of financing or the real underlying value of the property.

* Inadequate Loan Servicing - The separation of the servicing function from the origination function can lessen the accountability of institutions that originated loans. This separation tends to place the borrower in a position where information and loan counselling is not readily available or where the representations made at the time the borrower was selecting his financing cannot be verified.

* Special Lending Offers or Excessive Pressure - In weak or overbuilt markets there is sometimes excessive involvement by third parties such as builders and sellers, anxious to move products. This may include "special" deals, the movement of funds outside of closing or exceptions to the loan approval process. These arrangements may appear to be in the borrower's interest at first but later turn sour.

* Inflated Appraisals - Probably one of the least noted but key problems affecting the consumer is poor quality home appraisals. One appraiser recently highlighted this in a recent issue of the Appraiser Review Journal with an article entitled "You Can't Have Fraud Without an Appraisal." He summarized the problem as follows:

> "Our experience indicates that there is a direct relationship between poor quality loans and poor quality appraisal reports. An examination of loan packages that are in default revealed that 29 out of 37 properties were over appraised, many substantially. Further, a large sampling of loan appraisals, from properties that were not in default, revealed that [illegible]% of the appraisers listed sales price as market value. If sales price is market value, the lender

> doesn't need the appraiser. The lender already knows the sales price."

Because the consumer pays for and often relies upon an appraisal as a reasonable check of market value when he buys his home and decides upon financing, he deserves a quality appraisal. Problems can arise when an appraiser has a special relationship with a lender or developer that can affect his ability to provide independent judgments.

Courses of action are needed to stem the level of fraud and other consumer problems. This includes education on behalf of the borrowers. Mortgage insurers are on the same side of the transaction as the consumer and have seen clear evidence that informed consumers are better risks against default.

The consumer's need for information concerning ARMs are greater than for other instruments due to the complexity of ARMs. He needs to know about the instrument and terms (i.e., type of index, size of margin, caps, etc.) and he needs to have some idea about the expected performance (i.e. what can happen if rates change and what happens over time to the size of the loan obligation).

At the present time the information the consumer receives is in many cases insufficient. For one thing, the terminology and the form of disclosure that is provided by various institutions is not uniform and this makes comparison shopping of financing more difficult. There should be one required uniform disclosure method for all institutions regardless of who regulates them and whether they are a bank, savings and loan, mortgage banker, etc.

At the end of last summer, the Housing Subcommittee of the House Banking, Finance and Urban Affairs Committee asked the Federal Reserve Board and the other federal financial regulatory agencies to help homebuyers by developing a consumer brochure on ARM loans. This brochure was recently published by the Federal Reserve Board and while reflecting a positive effort, it falls short of meeting the consumer's need for truly effective ARM information. The Subcommittee also requested that the regulators consider amending federal regulations to include a requirement that lenders disclose the worse case scenario on adjustable rate mortgages.

MICA's analysis of a consumer's disclosure needs indicates the greatest progress would come from developing practical and simply understood guides that would categorize loans with reasonable levels of risk for the consumer. MICA has spent considerable time developing recommended uniform guides to help bring more uniformity to ARM loans. We believe that if a basic category of loans with reasonable repayment risk for borrowers could be established, it would encourage greater uniformity and help guide both the consumer, the lenders and the secondary market in their decision making.

In order to improve the ability of consumers to understand how loan types are likely to perform in the future, all mortgage insurers have started collecting data on ARM loans on a uniform basis. FHLMC now requires, as part of its Eligibility Requirements For Private Mortgage Insurers, a list of 21 elements of information that the insurer must collect from the lender with an application to insure a loan. This uniform data collection will aid this industry, the secondary market, and possibly the consumer as experiences with various loans develop.

In the last session of Congress the Senate considered an amendment that would impose lifetime caps on all ARMs. In our view this amendment would not be necessary if sufficient information was required to be given to consumers for them to understand the risks involved. Abusive financing techniques are not successfully marketed when the consequences of the terms and conditions are revealed. MICA strongly believes that the private market has the ability to correct problems in a self-regulatory fashion as long as adequate information is provided in a uniform and understandable way. The approach MICA recommends, using conforming risk guides, is included as an appendix.

Another concern related to disclosure results from the fact that inflation based home financing methods have been carried over from a period of higher inflation. We are seeing a significant number of homebuyers running into unexpected or unforeseen difficulties from deteriorated equity positions. The most common example is that of builder buydown loans that reduce, usually for a temporary period, the borrower's financing cost of the home in order to make the purchase possible. This technique has been exploited by builders to reduce home inventory with the justification that past rates of inflation would soon balance the homebuyer's lower level of initial equity with the size of his mortgage obligation. Large financing concessions have been incorporated in the selling price of the home and when stable or declining home prices occur, these overly aggressive financing techniques become totally unacceptable for the homebuyer.

MICA has been working with other trade groups and with the housing agencies, including Fannie Mae and Freddie Mac, to develop some reasonable standards that will identify the effect of financing in the appraisal. An important reason why so many consumer problems can result from builder buydowns and other financing techniques is the inadequacy of the appraisal process. Appraisals themselves can account for a large percentage of the misrepresentation that occurs in home purchases. MICA has asked the formal appraisal societies who monitor member performance to recommend and implement improvements to the appraisal process. Because fewer than 20% of appraisers have professional designations, we are beginning to doubt whether sufficient reform can occur without discipline being imposed by the users of appraisals. We believe the secondary market agencies, lenders and insurers should join and develop requirements that would assure the adequate quality in appraisals. MICA favors the recreation of a FNMA or FHLMC "Approved Appraiser List" as a practical tool for maintaining quality in appraisals and discouraging irresponsible parties from continuing to operate in mortgage finance.

The consumer deserves to know that the appraisers and the mortgage underwriters have accurately evaluated the value of the home he plans to purchase. Appraisals that hide unreasonable levels of builder paid financing discounts or other concessions in the value of the property are a market abuse that spell disaster for the unwary homebuyer.

The problems created by appraisals that do not reflect what the property is worth are compounded by utilization of the Federal Reserve Board's misleading method of calculating the Annual Percentage Rate (APR). Current Truth in Lending regulations on the APR steer consumers to abusive loans and to housing with inflated prices. Under these regulations, when a developer pays thousands of dollars to a lender for a buydown of the mortgage and passes that cost on to the consumer, that financing cost is not reflected in the advertised annual percentage rate. Accordingly, when the consumer utilizes the APR for what it is intended -- comparing financing costs -- he is comparing a very low APR, not reflecting all the financing costs, with other higher and more accurate APRs, which include all financing costs. The result is very easy to predict; many consumers, relying on a federally approved standard for comparing financing costs, will opt for the low APR and sometimes abusive loan. In addition, the consumer generally will be paying a greater purchase price for the house than he would have for a comparable house without such financing. Consumers may be better off with no regulations than with regulations that provide government legitimacy to the passing out of false lending information.

MICA believes that the Federal Reserve Board should revise the Truth In Lending regulations to prevent the misuse of the APR. The Federal Reserve Board should (1) require that the value of concessionary financing be included in the APR index, which would enable the consumer to compare financing costs accurately, and (2) require disclosure of the value of concessionary financing paid for by the seller.

The goal of reform for improved loan quality is of major interest to investors in the secondary market. During periods of volatile interest rates, the secondary market has helped to keep alive the fixed rate mortgage as a financing alternative. This can be important for consumers because it helps establish a national mortgage rate as rate differentials between cities are eliminated. This national rate for fixed rate financing can be used to compare financing costs of instruments that shift interest rate risk to the borrower. MICA has made its strongest warnings to consumers to beware of financing arrangements that purport to offer funds at costs substantially out of line with market rates.

Another important function of the secondary markets is to attract funds for housing from the capital markets. Therefore, it is important to consumers that mortgage instruments be acceptable to the secondary markets in order to augment the supply of housing credit. Loan originators have been finding greater consumer demand for ARMs that have some limits on payment increases but such loans often mean asset yields may not adjust simultaneously with yields of other market securities. Thus, when investors consider the potential impact of instrument design upon investment returns their uncertainty initiates resistance. This frustrates the fundamental purpose of the secondary markets to increase the supply and reduce the cost of mortgage credit to the homebuyer.

MICA believes the solution to gaining ARM acceptance into the secondary market is to see greater uniformity in the type of loan instrument and loan characteristics. Greater standardization in ARM loan features will occur as an experience base is developed that will provide an actuarily determinable risk rating for loan types. A comprehensive and consistent data base will proceed if all participants in the primary and secondary markets are organized to collect the necessary data in a uniform manner. This should be considered within the review of uniform disclosure methods that the regulatory agencies need to undertake.

Over a year ago, MICA suggested that an independent Mortgage Underwriter's Laboratory be established whose purpose would be to develop a data base and risk model that could be available to test and risk rate mortgage designs. Years ago an underwriter's laboratory for electric appliances was developed for the consumer's benefit and resulted in greatly improved product safety and a subsequent expansion of the markets for new products. A mortgage underwriter's laboratory could have the same effect on the mortgage loan market stimulating greater investor acceptance and participation. For the idea to be feasible, it needs the support of the federal secondary agencies and loan originators who may need to look past what they think are temporary conflicts with their competitive marketing goals. In the long run a mortgage underwriter's laboratory would greatly benefit both lenders and consumers and we would welcome further investigation of this concept.

In sum, the ARM loans have demonstrated benefits to the housing market. There are problems with some financing techniques and other practices but the market is making adjustments. Adjustments will occur more rapidly, however, if improved disclosure and understanding is achieved and this is a proper regulatory objective. MICA appreciates this opportunity to express our views.

APPENDIX

LOANS WITH PAYMENT ADJUSTMENTS
"CONFORMING INSTRUMENTS"
as recommended by
MORTGAGE INSURANCE COMPANIES OF AMERICA (MICA)

A. MINIMUM INITIAL BORROWER PAYMENT RATE

- * INDEXED LOANS: 200 basis points less than the full interest rate (index plus highest margin) subject to a floor of 250 basis points below the prevailing rate for fixed rate mortgages.

- * NON-INDEXED LOANS: 300 basis points less than the full interest rate.

B. PAYMENT CHANGE LIMITS

MONTHS SINCE ORIGINATION OR LAST PAYMENT ADJUSTMENT	MAXIMUM PERCENT * PAYMENT INCREASE
0-11 mos.	0
12-23 mos.	7.5% **
24-47 mos.	15.0%
48-59 mos.	20.0%
60 mos. or more	25.0%

* These payment percent charges can be translated into 1%, 2%, 2.75%, and 3.5% payment rate increases respectively. This should not be construed as putting caps on the loan interest rate.

** Annual payment increase limit is 15.0% (for a 12-23 month loan) if loan has all of the following features:

(1) maximum 90% LTV ratio
(2) no negative amortization
(3) maximum 5% lifetime rate cap, based on initial payment rate.

C. NEGATIVE AMORTIZATION

- * If loan balance is greater than 95% of original property value on any loan anniversary date, loan must be recast, i.e., increase monthly payment to amortize outstanding loan balance over remaining term, subject to payment increase limits.

- * Scheduled negative amortization is not permitted on loans exceeding 90% initial loan-to-value ratio.

Senator GORTON. Thank you.
Ms. Caplan.

STATEMENT OF DIANA L. CAPLAN, REALTOR, NATIONAL ASSOCIATION OF REALTORS

Ms. CAPLAN. My name is Diane Caplan. I'm here representing the National Association of Realtors. I'm a realtor in Santa Barbara, CA, but I think what I need to disclose to you is that I also own a mortgage brokerage firm in Santa Barbara.

I would consider myself to be a street person in that day in and day out I manage 14 loan officers, a staff of underwriters. I deal with consumers and realtors 16 hours a day.

So I would like to share with you some of the concerns from the National Association of Realtors, and I will be interjecting some of the concerns from the California Association as well.

We all know how the ARM was conceptually born and how it's been raised but I'd like to share with you from our October survey, 55 percent of all first mortgages are fixed rate mortgages.

OCTOBER MORTGAGES—34 PERCENT ARM'S

Many of those in this room would probably prefer to have a fixed rate than to have an animal that will adjust over a 30-year period. However, we must realize that 34 percent of the mortgages in October were adjustable rate mortgages. What we are trying to strive for is a balance between the lender risk and the consumer awareness and the consumer risk.

In our survey, there are three things we would like to point out. No. 1, three out of every four borrowers select a payment adjustment cap. No. 2, 7 out of 10 ARM's are usually tied to the 1-year Treasury security. No. 3, 9 out of 10 ARM's will be taken by homeowners that will not allow negative amortization.

As one of the other speakers pointed out, if the consumer elects a 7½ payment cap, the possibility of the principal amount does grow.

I would also like to point out that there is a projection among lenders that due to the servicing—as you did mention—the fee will probably increase by about one-eighth of 1 percent because of the complexity in keeping track of the bookkeeping as the different indices and the margins grow or decrease. And that has to be revealed back to the borrower.

I would also like to share with you that loan officers and loan servicing staff are now expending considerably more time in explaining to consumers what is going on and what their options are in the field.

As we discussed, there are a number of articles and disclosures that are out. The booklet that went around the table a few minutes ago, the National Association of Realtors has put out 1 million of those copies. The California Association came out with their disclosure, "How to Shop for a Loan," with 16 questions to ask. So education is taking place across our Nation.

However, the National Association of Realtors 1 year ago set up a task force—I am the cochairman of that task force—to investigate disclosure of ARM's.

We have come up with a 14-point format. That is our attachment B. It's an attachment that we would like to see as a disclosure form used by all the regulatory agencies. Whether a consumer goes into a bank, a savings and loan, a mortgage company——

Senator GORTON. Ms. Caplan, let me interrupt. While you're speaking about that, speak to whether or not realtors, as an organization, are interested in educating prospective home buyers about adjustable rate mortgages as against seeing to it that these various other agencies do so. But go ahead.

Ms. CAPLAN. Do you want me to address that now in my 5 minutes?

Senator GORTON. As part of the subject you're on right now.

Ms. CAPLAN. Realtors have undertaken a project to write their own disclosure forms and to publish their own pamphlets on how to shop for a loan. And a number of realtors have banded together to go out and teach at local boards of realtors across our Nation on how to shop for loans.

No. 1, the realtor has to understand foremost the complexity of the ARM if they are going to advise consumers so that's a real movement just from the grassroots, from the local boards of realtors.

Does that answer your question?

Senator GORTON. Yes. Go on.

Ms. CAPLAN. OK.

I would like to get back on track with the model format that we have designed that we have offered to all the agencies.

Key to our recommendation is the demonstration of the worst case scenario, or a 5-year projection of what would happen to that home owner when the payments do change.

TIMELY DISCLOSURE

Another element we are really concerned with is the timely disclosure. We would recommend that upon loan application, just like when in truth and lending, with regulation Z. Usually after application within 3 days, we instruct our loan officers and our underwriters to put out the APR to be in conformance. It would be very simple for underwriters at the same time in institutions to disclose fully the components of the ARM rather than waiting till when a consumer would come in and sign the loan document.

Usually, escrow closes 2 to 3 days—maybe 5 days—after that and by that time, they just usually sign the documents, quite frankly, and take the loan that they're offered.

I need to also say that even though we have been working with all the agencies on this, we are prepared to take the legislative initiative because we feel this is something that needs to be standardized across our Nation.

I also would like to take this opportunity to comment on truth in lending as it specifically relates to assumption policies. We are experiencing, among the realtors that a loan—especially an ARM if it is to be assumed—we find out when the consumer goes in to assume the loan that the loan is really transferable in that several lenders are resetting especially the life cap on the loan or certain terms are being changed.

I can tell you firsthand as a realtor, that this is taking place in our country. We were very disappointed when we learned that the Fed is now going to allow a negative statement, a statement such as "the uncertain nature of the future assumption" should be reflected in the disclosure.

Any of us in this room know, I would hope, that that is double talk. It would be far easier just to say that the mortgage "cannot be assumed in its original term." That's understandable by all of us.

I need to share with you three concerns that are taking place. No. 1, teaser rates are prevalent. Rates are being offered at around 9, 9½, 10 percent. When we have our first adjustment—let's say it's tied to the 1-year T bill at 9.79 or 0.8 with a 2½ margin. That means that the 7th month or the 13th month that payment shock or that rate will be approaching 13 percent. Teaser rates are prevalent.

No. 2, underwriters are having a problem in calculating true APR on adjustable rate mortgages unless they own a really sophisticated computerized system. It's hard for those gals to be retrained and to put out a true APR.

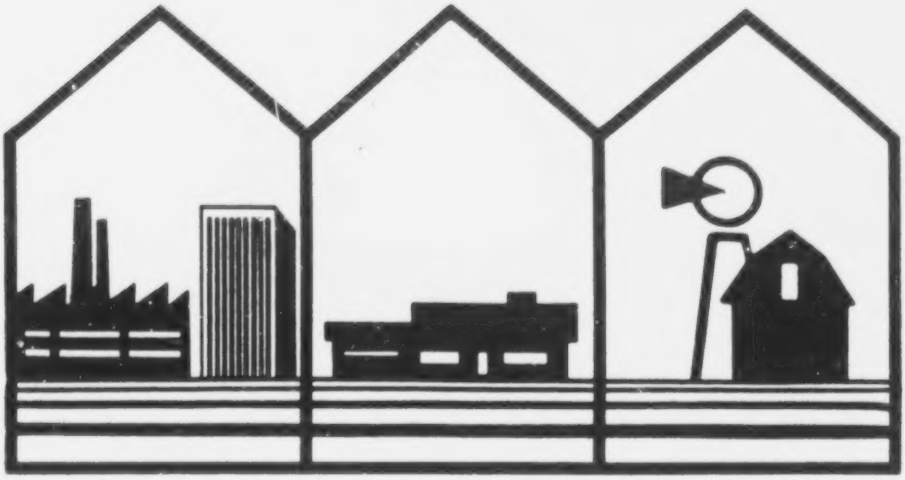
Also, No. 3, there are problems in servicing. If a consumer took out a loan—a 7½-percent payment cap—and elected to pay a larger payment so that the deferred interest wouldn't grow on the balance, when that payment is made, many lenders are crediting that to the principal, not the deferred interest. So interest is being compounded and this is another concern that is very prevalent.

I also need to take some time right now to explain something that is going on and that's in regard to prepayment penalties, in regard to due-on-sale.

When a lender comes forward and says a loan is not assumable, and the borrower elects to refinance, technically, it is accelerated. And by this what I mean, when a customer comes into our office and refinances a loan, several lenders—because it is not being purchased by another consumer—our prepayment penalty is being imposed. And this is what we are referring to in our background paper here as a double-whammy.

In conclusion, I've covered many topics and I hope that you may have some questions, especially as it may relate to our model format that we would like to see implemented across the United States. Thank you.

[The complete prepared statement follows:]



Statement of the

NATIONAL ASSOCIATION OF REALTORS®

THE WORLD'S LARGEST TRADE ASSOCIATION

TO:	SENATE SUBCOMMITTEES ON FINANCIAL INSTITUTIONS AND HOUSING AND COMMUNITY DEVELOPMENT (SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS)
ON:	ADJUSTABLE RATE MORTGAGES (ARMs)
BY:	DIANA L. CAPLAN
DATE:	APRIL 19, 1985

Good morning, Chairman Gorton and Chairman Hecht, my name is Diana L. Caplan, and I am a REALTOR® from Santa Barbara, California. I am a member of the NATIONAL ASSOCIATION OF REALTORS® Real Estate Finance Committee and Co-Chair of the REALTOR® ARMs TASK FORCE. On behalf of the over 670,000 members of the NATIONAL ASSOCIATION OF REALTORS®, I want to thank you for the opportunity to present our views on Adjustable Rate Mortgages (ARMs).

ADJUSTABLE RATE MORTGAGES: A NECESSARY MARKET INNOVATION

Since the 1930's, the fixed-rate mortgage has been the staple of home financing. Because of it, millions of Americans have been able to join the ranks of real estate owners. As we all know, however, with the runaway inflation and rising interest rates of the 1970's, it soon became apparent that the traditional form of housing finance would require alteration. For lenders, paying out more interest than they took in on their mortgages was a prescription for disaster.

Market conditions clearly called for a mortgage instrument which would be tied more closely with the fluctuating cost of money, and better allow lenders to match their assets and liabilities. The adjustable rate mortgage was developed from these needs, and has become an important alternative mortgage financing tool.

Since its inception, we have monitored the growth and performance of the ARM in the marketplace. While we strongly support the continued availability of the standard, fixed-rate mortgage (FRM), we recognize that the ARM, as an alternative financing option, has placed homeownership within the reach of millions of Americans, particularly first-time homebuyers. To ensure the future success of the ARM, our members have consistently maintained that the credibility and viability of this instrument must be preserved by assuring that a proper balance is struck among the marketability of the ARM, its ability to protect lenders from interest-rate risk, and the risk to the consumer. In fact, because of the importance of this and other issues surrounding adjustable rate mortgages, the Association formed a special REALTOR® ARMs TASK FORCE last year to study these matters.

Before I provide the Subcommittee members with a summary of the Task Force's recommendations, I would like to share the results of our most recent survey on the use of ARMs in the marketplace.

ADJUSTABLE RATE MORTGAGES: RECENT MARKET TRENDS

According to our most recent survey, traditional fixed-rate loans accounted for over one-half of all first mortgages financed in October, 1984, while adjustable rate mortgages amounted to just over one-third of all first mortgages. In percentage terms, fixed-rate loans comprised 55 percent of total first mortgages; ARMs totalled 34 percent. These figures vary little from our June 1984 survey which showed FRMs at 54 percent and ARMs at 36 percent. Although the October data indicates that ARMs did not experience any further increase in market share of first loans since spring, they were three times the levels of 1983.

The recent slight decline in the use of ARMs is not due to a scarcity of ARMs being offered in the marketplace. In fact, our data shows that adjustable rate mortgages are more widely available than fixed-rate mortgages in all market areas of the country. The cause of the recent increase in homebuyers' preferences for fixed-rate mortgages is likely the result of a narrowing of the interest rate spread between ARMs and FRMs, more conservative underwriting procedures for ARMs, and higher mortgage insurance premiums for ARM users.

The results of our survey also indicate that almost all consumers are choosing to limit their risk by selecting ARM plans which place caps on the amount their payments can increase. According to the October data, nine out of ten borrowers selecting an ARM loan chose a plan with a cap on both the periodic adjustment and the total adjustment over the life of the loan.

With regard to the various characteristics of ARM loans selected last fall, our findings show the following:

- The majority, three out of every four borrowers, selected an ARM with payment adjustments occurring once each year.
- The most popular indexes selected by consumers, chosen in seven out of every ten ARMs, were the U.S. Treasury Security indexes, most significantly the one year treasury note.
- Nine out of ten ARMs taken by homebuyers last fall did not allow negative amortization.

Our survey results also indicate that ARMs may be priced higher in the future than they have been previously. This is due to the fact that lender costs associated with servicing mortgage loans are much greater for ARMs than for conventional fixed-rate mortgages. Lenders have now built these higher costs into ARM servicing fees and, therefore, into the interest rates charged on ARMs. ARM servicing is much more labor intensive. In addition to recording and collecting monthly payments, servicers are now required to track all available ARM indexes, change interest rates and payments when necessary, and notify borrowers of any and all changes.

Furthermore, because ARMs are more complicated instruments, loan officers and the loan servicing staff must now spend more time explaining how ARMs work and why any payment and rate adjustments were made. Some lenders estimate that the increased cost for servicing ARMs amounts to roughly one-eighth of a percent (17.5 basis points) per month over the cost of servicing fixed-rate loans. (Currently, most lenders charge 37.5 basis points for servicing a fixed-rate loan.)

For the Subcommittees' information, two articles from the Association's publication, the Real Estate Quarterly (Vol. 4, no. 1, Winter 1985) are attached to our testimony and outline in further detail the results of our fall 1984 study. (SEE ATTACHMENT A)

THE IMPORTANCE OF ADEQUATE DISCLOSURE ON ADJUSTABLE RATE MORTGAGE LOANS

Chairman Gorton and Chairman Hecht, one of the chief issues of concern for the Association is the subject of disclosure on ARM loans. Because of the complexity of ARMs, it is important for potential homebuyers to fully understand all the features of the adjustable rate mortgage they are purchasing. Disclosure was the subject of considerable study, review, and debate by the REALTOR® ARMs TASK FORCE. From the beginning, the Association has taken a very strong and committed position in favor of the provision of adequate, proper, and meaningful ARM disclosure. We strongly believe that adherence to disclosure requirements should be monitored closely by the appropriate regulators and abuses corrected as quickly as possible. All parties--lenders, consumers, and REALTORS®-- will benefit from a strong disclosure mechanism which will ensure consumer confidence in the ARM instrument.

Numerous government agencies have attempted to address the ARM disclosure issue in recent years. The Federal Home Loan Bank Board (FLHBB) published disclosure requirements for a wide variety of adjustable type mortgage instruments in 1982, the Federal Reserve Board (FED), and the Office of the Comptroller of the Currency (OCC) have also promulgated regulations, and last year HUD included specific disclosure rules in the FHA-ARM program. However, to date, no regulatory authority has adopted or imposed a standardized ARM disclosure format. To the contrary, the FED grants lenders complying with either the FHLBB or the OCC regulations an exemption from its own rules.

The NATIONAL ASSOCIATION OF REALTORS® advocates both the standardization and strengthening of disclosure requirements among the various lenders. We believe that whether a consumer deals with a commercial bank, a savings bank, or any of the financial institution hybrids, the disclosure requirements and documentation should be the same for comparison purposes. This type of "functional regulation" will not only make it easier for consumers to compare ARM plans, but it should make non-compliance with disclosure requirements easier to detect and enforce.

In an effort to contribute toward the achievement of this goal, the REALTOR® ARMs TASK FORCE, as part of its study, developed a proposed ARMs Model Disclosure Format. In January of this year, our recommended Model format was distributed to the regulators, Congress, and the various housing and financial institution trade associations. A copy was sent to the Chairman of the Senate Banking Committee, Senator Garn, and a copy of our proposal is also attached to our statement. (SEE ATTACHMENT B) Key to our recommended format and to any set of uniform disclosure requirements is the provision of a hypothetical example or scenario demonstrating the changes in the consumer's monthly payments.

Another element of the process just as important as the content of disclosures involves the timing factor. We are concerned that disclosure be provided at the earliest opportunity in the loan process, preferably prior to payment of any application fees, so that the borrower can utilize the information to properly compare instruments.

Since distributing our proposed Model, we have met with representatives of the Federal Reserve Board to discuss the possibilities of implementing uniform disclosure requirements. It is our understanding that efforts are currently being made to produce such a document.

While the Association recognizes that reaching agreement among all parties on a uniform disclosure format is a difficult task, we believe that promulgation of such a document is so important to consumers and our industry, that we will work toward a legislative initiative to implement uniform requirements, if a regulatory solution is not possible. We strongly urge Congress to press the regulatory agencies to adopt a single set of uniform disclosures.

We have offered to meet with interested parties to discuss this important issue, and we continue to be open to such a dialogue.

On a related disclosure matter, I would like to use this opportunity to express the Association's concerns about a recent regulatory change made by the Federal Reserve in its official staff commentary interpreting Regulation Z (Truth-in-Lending).

In its original proposal, the FED amended its staff commentary with regard to disclosures relative to lenders' assumption policies and required lenders to make a "negative" rather than an "affirmative" disclosure when uncertainty exists regarding the complete assumability of a mortgage. In our comment letter to the FED, the Association strongly supported this amendment. Our members have reported instances where lenders have imposed one or more punitive conditions--such as adjustment of the margin, or of the annual or lifetime interest rate cap--yet advertised the loan as "assumable."

Following the comment period on this proposal, the Federal Reserve Board recently issued a final rule implementing the changes to the Official Staff Commentary. The Association was very disappointed to learn that the FED's original proposal has been altered from a requirement of a "negative" disclosure to one in which the "uncertain nature of a future assumption should be reflected in the disclosure..."

The Association strongly believes that this alteration dilutes the nature and intent of proper and meaningful disclosure and that requiring lenders to state that a mortgage "cannot be assumed on its original terms" is a better approach and will alleviate most consumer concerns in this area.

MARKET PRACTICES

Chairman Gorton and Hecht, our members in the field have reported several practices occuring in the marketplace with respect to ARM loans which we would like to bring to your attention:

- "Teaser" Rates: Many of the initial concerns raised last year about "payment shock" associated with ARMs emanated from the offering and use of "teaser" rates in the marketplace. While it is being reported that "teaser" rate loans are virtually nonexistent in the marketplace, our members have provided us with instances in which lenders are still offering discounted ARM interest rates ranging from 1 to 4 percentage points. Therefore, the issue of "payment shock" in some market areas, remains a legitimate concern.

- Advertising of the Annual Percentage Rate (APR): Despite Regulation Z requirements, our members also report that inaccurate calculation of advertised APRs is occurring particularly when involving discounted ARMs.

- Servicing Problems: Reports from the field also mention that, in some cases, errors are being detected in the calculation of borrowers' payment adjustments, resulting in over-payment. Cases have also been reported of inaccurate crediting of higher borrower payments (to avoid negative amortization) to principal and not interest, as intended.

CONSUMER EDUCATION/INFORMATION

The NATIONAL ASSOCIATION OF REALTORS® believes that consumer education, through the dissemination of appropriate information on ARMs, is a natural and necessary adjunct to disclosure. The provision of clear, concise, and understandable educational materials can, we believe, go a long way toward ameliorating consumer confusion associated with adjustable rate mortgages (ARMs).

The NATIONAL ASSOCIATION OF REALTORS● participated in the review of the recently issued Consumer Handbook on ARMs, which was produced under the auspices of the Federal Reserve Board and the Federal Home Loan Bank Board. We recently distributed one million copies of the Handbook to REALTORS● in every State of the country, who are distributing them to the public. We will also be printing additional copies for those states who require them.

We also applaud the efforts that the housing industry has undertaken in producing educational materials for consumers on adjustable rate mortgages.

PREPAYMENT/DUE-ON-SALE

While we recognize that the focus of these hearings is on adjustable rate mortgages, the Association wants to bring to the Subcommittees' attention an issue which has been our concern for some time and which warrants close review. The issue involves the assessment of prepayment penalties involving acceleration of due-on-sale clauses.

In response to the Garn-St. Germain Depository Institutions Act of 1982, the Federal Home Loan Bank Board promulgated regulations which initially reversed its longstanding policy prohibiting a prepayment penalty "in conjunction with" the exercise of a due-on-sale clause acceleration. Industry pressure convinced the Bank Board to reinstate its old policy, but the trigger clause, "in conjunction with", was never clarified.

As a result of this confusion regarding the application of the regulation, lenders began to exploit the ambiguity. Consumers found themselves the victim of the "double whammy". This situation occurred when the lender would not permit a loan to be assumed; therefore, it was necessary for the consumer to refinance the loan. At the same time, the lender would demand a prepayment penalty from the consumer claiming that a simple refusal to permit an assumption which had the effect of forcing a refinance was not an acceleration of the due-on-sale clause and therefore, was not a prohibition of the prepayment penalty. In this scenario, the consumer ends up refinancing the loan, usually at a higher interest rate, and paying a prepayment penalty. Thus, the creation of the "double whammy".

Last Spring, representatives from both the NATIONAL and CALIFORNIA ASSOCIATION OF REALTORS® met with the General Counsel of the Federal Home Loan Bank Board to discuss implementation of a clarifying regulation which would prohibit lenders from imposing prepayment penalties for or in connection with the acceleration of loans by the exercise of the due-on-sale clause.

In August, 1984 the Bank Board issued a propsed regulation which attempted to further define the appropriate timing of a prepayment penalty. The NATIONAL ASSOCIATION OF REALTORS® filed comments on this regulation along with California and other State Associations.

Chairman Gorton and Hecht, the NATIONAL ASSOCIATION OF REALTORS® has been working on this matter for over a year, and we are most anxious to resolve the serious consumer problems associated with it.

As Chairman Garn and other members of the Committee have previously expressed an interest in this subject, we want to alert you of our continuing efforts.

CONCLUSION

In conclusion, Chairman Gorton and Chairman Hecht, adjustable rate mortgages have clearly become a significant alternative mortgage financing tool, although there has been a slight decline in their use. Whether or not their market share will increase or decrease in 1985 is dependent upon a number of factors and is uncertain.

THE NATIONAL ASSOCIATION OF REALTORS® continues to advocate the adoption of standardized, uniform disclosure requirements, and believes that adequate disclosure and consumer education are key to the future success of adjustable rate mortgages. We also recommend that compliance with existing disclosure requirements, as well as market practices, continue to be monitored closely and enforced by the regulators. We stand ready to assist in any of these endeavors.

Thank you once again for the opportunity for present our views. I will be pleased to answer any questions the Subcommittee may have.

ATTACHMENT A

MORTGAGE FINANCE

Recent Trends In Mortgage Finance — Instruments Used And Sources Of Funds

Mortgage markets continue to reflect a return to the utilization of single mortgage financing from traditional sources. This fall more than 85 percent of all home sales were financed solely by a first mortgage loan and almost three out of every four of these were supplied by financial institutions. Traditional fixed-rate loans comprised just over one-half of all firsts while adjustable-rate mortgages (ARMs) were one-third of all first mortgage loans. These conclusions are based, in part, on a recent survey of the financing techniques used in home sales brokered by members of the NATIONAL ASSOCIATION OF REALTORS®.

Use of Mortgages

Fully, 86 percent of home sales transactions last October involved only a first mortgage. This is a continuation of a trend that began in late summer, 1982 and reflects the fact that lower interest rates have allowed homebuyers to finance their purchases primarily with a single loan. Just under one in ten home sales were financed using a first and second mortgage and virtually no sales involve a third mortgage note. Roughly one in twenty sales were all-cash arrangements not involving mortgage financing.

Types of First Mortgages

The use of first mortgage instruments last October almost exactly paralleled their use in the spring 1984 market. Traditional fixed-rate loans accounted for over one-half of first mortgages and adjustable rate loans (ARMs) accounted for just over one-third of all first mortgages. Last spring, fixed-rate loans were 54 percent and ARMs were 36 percent of all firsts. Even though ARMs did not experience any further increases in market share of first loans since spring, they were three times the levels of 1983.

Traditional fixed-rate loans accounted for over one-half of first mortgages and ARMs accounted for just over one-third of all first mortgages.

When these most recent figures are adjusted to represent *new originations of first mortgages* (i.e., excluding assumptions), ARMs account for about 39 percent and fixed-rate loans about 49 percent of *newly originated* first mortgages. By comparison, in the spring 1984 market, ARMs were 43 percent and fixed-rate loans were 46 percent of new firsts.

The factor which probably best explains this recent decline is the narrowing in the differential between interest rates on fixed-rate mortgages and ARMs. This spread narrowed in the spring and early summer as short-term interest costs, to which many ARM interest rates are tied, rose in response to Federal Reserve policy and the increasing demands for credit imposed by consumers and the Federal Government. (See the following article for further analysis of the decline of ARMs.)

Graduated payment mortgages, land contracts, wraparound mortgages, and short-term mortgages with balloon payments collectively accounted for about ten percent of all first mortgages last October while equity participation and share equity loans were virtually non-existent.

MORTGAGE FINANCE TRENDS

FINANCING OF HOME PURCHASES
(Percent of Transactions)

Mortgage(s)	October 1984	June 1984	September 1983	April 1983	August 1982
First Mortgage only	86	85	82	78	62
First and Second Mortgage	9	9	10	11	20
First, Second, and Third Mortgages	0	1	1	2	3
Other (primarily cash sales)	5	6	7	9	15
	100	100	100	100	100

Sources of First Mortgages

Financial institutions provided almost three out of every four first mortgage loans last October — roughly the same fraction they supplied in the spring of last year.

Assumptions of existing loans this fall accounted for just under 20 percent of first mortgages, about the same percentage as in the spring. Although assumptions of firsts are up very slightly from the fraction in June, they still have not returned to the levels provided in the spring and fall of 1983. The continuing availability of ARM loans at moderate interest rates probably accounts for some of the decrease in the use of assumptions in 1984 relative to prior years. However, lender enforcement of due-on-sale clauses also has lowered their availability and use.

Seller financing of first mortgage loans this fall was up slightly from the spring market, and equaled the level recorded at the end of the summer of 1983. Although this most recent increase over the last four months is small, it suggests a potential for an increasing reliance on sellers as a source of mortgage funds if interest rates rise further in 1985.

Second Mortgages

Second mortgage loans were involved in about one in ten home sales this fall, the same rate as last spring. Two years ago, however, more than 20 percent of sales transactions involved second mortgages.

Over 40 percent of second mortgage loans last fall were of the traditional fixed-rate variety, a continuation of a trend over the past two years. Short-term balloon mortgages were also used frequently for second mortgages closely rivaling the fixed-rate loan. In fact, the use of balloons was up somewhat from June 1984.

Adjustable-rate loans accounted for six percent of second loans in the fall, double the share they held in the spring and three times the level of a year ago. This suggests a possible

INSTRUMENTS USED AS FIRST MORTGAGES
(Percentage Distribution)

Instruments	October 1984	June 1984	September 1983	April 1983	August 1982
Traditional Fixed-Rate	55	54	63	76	52
Adjustable-Rate Mortgage (ARM)	34	36	22	10	10
Graduated Payment Mortgage (GPM)	2	3	5	4	4
Land Contract	3	2	2	3	9
Wraparound Mortgage	1	*	1	*	2
Short-term Mortgage with Balloon Payment	4	3	5	4	10
Equity Participation Mortgage	*	*	*	*	1
Other	1	1	2	3	11
	100	100	100	100	100

SOURCES OF FIRST MORTGAGES USED IN FINANCING HOME PURCHASES
(Percentage Distribution)

Source	October 1984	June 1984	September 1983	April 1983	August 1982
Financial Institutions	72	74	66	61	33
Assumptions	18	17	22	22	41
Sellers	8	6	8	10	18
Other	3	3	4	6	8
	100	100	100	100	100

INSTRUMENTS USED AS SECOND MORTGAGES
(Percentage Distribution)

Instrument	October 1984	June 1984	September 1983	April 1983	August 1982
Traditional Fixed-Rate	44	46	46	41	42
Adjustable-Rate Mortgage (ARM)	6	3	2	*	*
Graduated Payment Mortgage (GPM)	*	*	2	*	1
Land Contract	3	4	2	4	3
Wraparound Mortgage	*	7	6	4	4
Short-term Mortgage with Balloon Payment	43	37	37	50	41
Equity Participation Mortgage	*	1	*	*	1
Other	4	2	5	*	7
	100	100	100	100	100

SOURCES OF SECOND MORTGAGES USED IN FINANCING HOME PURCHASES
(Percentage Distribution)

Sources	October 1984	June 1984	September 1983	April 1983	August 1982
Sellers	55	56	57	58	65
Financial Institutions	36	23	26	20	20
Assumptions	4	6	7	10	11
Other	5	16	11	12	4
	100	100	100	100	100

*Less than one percent.

emerging role for ARMs in mortgage financing involving more than one loan. This most recent increase in balloons may be in response to the gradually increasing interest rates on ARMs and fixed-rate loans that began about the middle of the summer.

The few remaining second mortgages are comprised of wraparounds, graduated payment loans and equity participation loans. Wraparound mortgages were six to seven percent of seconds in early 1984 and late 1983 but declined in use in late 1984. One explanation for this decline is the reduction in assumable first mortgages which lenders are allowing to be wrapped. Furthermore, it is likely that if a first is assumed, the buyer would obtain the remainder of the financing by taking a second mortgage rather than wrapping the assumed first loan. This reasoning also helps explain the recent increase in short-term balloon seconds.

Sources of Seconds

Last fall, sellers were the most important providers of second mortgages, accounting for more than one-half of all of these loans. This proportion has been relatively unchanged since the spring of 1983.

Financial institutions now account for over one-third of all seconds — an increase of over 50 percent in the proportion that they were supplying last spring. This sudden jump in the provision of second mortgage loans by financial institutions probably accounts for the doubling in the percentage of ARM seconds occurring in the market.

Conclusions

Overall, conditions in this fall's mortgage market were very similar to the market of last spring. Financial institutions wre the major providers of first mortgage financing and almost nine out of every ten home sales was financed solely with a first mortgage. Sellers were still the major providers of second mortgages, although financial institutions substantially increased their involvement in this market through adjustable rate loans.

Nevertheless, there are some indications beneath the surface which suggest that this may be a transitional market. Adjustable rate mortgages, as a percent of *new first loans*, have declined since the spring. Whether or not ARM's will continue to loose some of their popularity is at this point, a matter of conjecture.

Adjustable Rate Mortgages — Market Shares Stabilize And Financing Becomes Standardized

For the first time since their authorization in 1981, adjustable-rate mortgages (ARMs) have failed to gain in market share. Based on Association surveys of the financing used in home sales, ARMs accounted for 36 percent of all first mortgages in June, and 34 percent in October. At the same time, the terms of ARMs continue to become more standardized as borrowers are demonstrating clear preferences for a narrow range of ARM options.

Reasons For Stable Market Share

The recent slight decline in the popularity of ARMs is not due to a scarcity of adjustable-rate mortgages being offered in the market place. In fact, ARMs are more widely available than fixed-rate mortgages in all market areas of the United States. More than 95 percent of survey respondents indicated that ARMs were widely available in their area during both June and October. In contrast, 57 percent of respondents indicated that fixed-rate mortgages were widely available in June, and only 62 percent reported fixed-rate loans widely available in October. The cause of the recent increase in homebuyers' preferences for fixed-rate mortgage financing is threefold — a narrowing of the interest rate spread between fixed rate mortgages and ARMs, more conservative underwriting policies for ARMs, and higher mortgage insurance costs for ARM users.

- **Narrowing of the Interest Rate Spread Between ARMs and Fixed Rate Loans**

From June to October, the spread between ARM and fixed-rate mortgage interest rates on the survey transactions declined 60 basis points. The average interest rate on all ARMs in October was 11.8 percent, up from 10.9 percent in June. The average interest rate on fixed-rate mortgages in October was 12.5 percent, up only slightly from 12.2 percent in June. The spread between the average interest rates on these instruments in October was 70 basis points, as compared to 130 basis points in June.

One reason for the narrowing of the mortgage interest rate spread between ARM's and fixed-rate loans is that lender costs associated with servicing mortgage loans are much greater for ARMs than for conventional 30-year fixed-rate mortgages. Lenders have now built these higher costs into ARM servicing fees and, therefore, into the interest rates charged on ARMs. ARM servicing is much more labor intensive. In addition to recording and collecting monthly payments, servicers are now required to track all available ARM indexes, change interest rates and payments when necessary, and notify borrowers of any and all changes.

Furthermore, because ARMs are more complicated instruments, loan officers and the loan servicing staff must now spend more time explaining how ARMs work and why any payment and rate adjustments were made. Some lenders estimate that the increased cost for servicing ARMs amounts to roughly one-eighth of a percent (17.5 basis points) per month over the cost of servicing fixed-rate loans. (Currently, most lenders charge 37.5 basis points for servicing a fixed-rate loan.)

Another reason for the narrowing of the interest rate spread between fixed-rate mortgages and ARMs is that the gap between long-term and short-term interest rates has narrowed. Mortgage lenders set ARM rates based on yields on short-term and medium-term U.S. securities. With three out of every four ARMs adjusting once each year, most of these instruments are priced off the yield on the one-year Treasury note. On the other hand, because fixed-rate mortgages generally have a term to maturity of 30 years, mortgage lenders have been setting rates on fixed rate mortgages based on market yields of long-term U.S. Treasury securities.

Thus, when the spread between long-term and short-term Treasury yields narrows as it has recently, a proportional narrowing between ARM and fixed rate mortgage rates results.

- **ARM Underwriting Policies**

Mortgage lenders have become much more conservative in their underwriting policies regarding ARMs than they were previously. This tightening has led to an increase in the amount of income needed to qualify the typical homebuyer for an ARM and reduced the affordability advantage that ARMs have had over fixed-rate mortgages.

Until recently, the borrower's ability to absorb potentially large increases in monthly payments from low initial mortgage interest rates was not fully taken into consideration by most lenders. Now, lenders have a much better understanding of the higher default risk inherent in ARMs, and have tightened their underwriting guidelines.

Under traditional underwriting procedures, lenders would calculate a borrower's monthly mortgage payment and divide this by the borrower's gross monthly income. If the ratio was less than or equal to 25 percent (less conservative lenders used 28 to 32 percent), the lender would make the loan. Initially, ARMs with discount interest rates were being underwritten in this manner. However, unless the borrower's income increased by as much as the increases in the ARM payments, the borrower might not be able to afford future mortgage payment increases, and might eventually default on the loan.

Current underwriting practice still uses the ratio test. However, the borrower's monthly payment is not calculated using the initial ARM mortgage interest rate. Instead, a composite rate which more accurately reflects the future costs of the mortgage is used. Generally, this composite rate is constructed by adding the ARM's index value at the time of origination to the margin required by the lender at each payment adjustment. The composite rate is generally less than the prevailing fixed-rate mortgage rate, but is above the initial ARM mortgage rate

- **Higher Mortgage Insurance Premiums**

Mortgage insurance for ARMs has increased and is now more expensive than insurance on 30-year conventional fixed-rate mortgages. Concerned about the possibility of default by those who had qualified for ARMs at discounted or low initial interest rates, mortgage insurers have raised annual insurance premiums on ARMs. Currently, the difference in premiums between fixed-rate mortgages and ARMs is running at about three-quarters of a point for the first year, with at least $1,000 more in out-of-pocket costs for premiums over a five- to eight-year period. Furthermore, the spread difference in interest rates between fixed-rate mortgages and ARMs does not include the higher cost of mortgage insurance for ARMs. These higher premiums for ARMs can be expected to further diminish the appeal of ARMs relative to fixed-rate mortgages.

Characteristics Of Current ARMs

As the use of ARMs has stabilized there has been a further standardization of options on these loans. They reflected in a comparison of the characteristics of ARMs taken last fall and last spring.

Almost all borrowers are choosing to limit their risk by selecting ARM plans which place caps on the amount their payment can increase.

Payment Adjustment Period. Last fall borrowers were taking ARMs with payment adjustment periods that ranged from intervals of six months up to five years. Three out of every four borrowers selected an ARM that had payment adjustments occuring once each year. A distant second choice among borrowers was a three-year adjustable accounting for less than 20 percent of ARM originations. Payment adjustment periods chosen in the September/October period were relatively unchanged from those for the spring and summer.

Interest Rate Indexes. Almost seven out of every ten ARMs taken by borowers last fall were tied to U.S. Treasury Security indexes, and almost three-fourths of those used the one year Treasury note. The average cost of funds index was the next most utilized index, comprising just under 20 percent of ARM loans. The Federal Home Loan Bank Board (FHLBB) Contract Rate was used as the index in roughly 12 percent of the loans.

There are some important similarities and differences in the use of indexes this fall when compared to those used in ARMs originated last spring and summer.

In today's market, 49 percent of ARMs taken by borrowers use the one year Treasury rate — roughly the same proportion used this index in June. A major shift occured through a halving in the frequency of use of the FHLBB Contract Rate and a doubling in the use of the Average Cost of Funds index. Last fall, almost one in four ARMs used the FHLBB contract rate; however, that proportion has dropped to 12 percent this fall. In contrast, the use of the Average Cost of Funds index doubled for ARMs taken this fall.

Borrower Use of Protective Caps. Borrowers takeing adjustable rate mortgages assume risks not associated with fixed-rate loans. The primary risk is a large and, perhaps, unmanageable jump in their monthly payments. Borrowers can limit this risk by selecting ARM plans which place caps on the allowable increase in the interest rate or monthly payment. Some ARM plans also place a cap on the maximum increase in the interest rate over the entire term of the loan.

Almost all borrowers are choosing to limit their risk by selecting ARM plans which place caps on the amount their payment can increase. Last fall almost nine out of every ten borrowers selecting an ARM loan chose a plan with a cap on both the periodic adjustment and the total adjustment over the life of the loan. Less than five percent of ARM borrowers selected plans which did not provide protective caps of any kind. By comparison, last spring and early summer just under 80 percent of ARM borrowers took plans providing both kinds of protective caps and 13 percent of ARM borrowers selected plans with no protection.

A typical ARM loan places a two percentage point cap on the interest rate in the periodic adjustment and a five percentage point cap on the rate over the life of the loan. However, many of these plans also limit the *decrease* in the interest rate that the borrower would enjoy during periods when interest rates are falling.

ARMs and Negative Amortization. In most ARM plans, protective caps prevent the payment adjustment from increasing to the level justified by the index in cases where the index has increased dramatically. This protects the borrower from sharp payment increases and usually involves no additional borrower liability of interest or principal to the lender.

However, in some ARM plans, an obligation of additional interest or principal is only postponed and the balance of the loan builds up through negative amortization.

In the fall market more than nine out of every ten ARMs taken by homebuyers did not allow negative amortization. This is a slight increase in the use of plans that do not allow negative amortization over those taken in the market of the early summer.

Another seven percent of the plans restricted negative amortization — that is, they allow the outstanding principal to increase up to a maximum of 125 percent of the initial principal on the loan. While this percentage is relatively unchanged from June, the fraction of ARMs taken by borrowers that allow unrestricted amortization dropped from seven percent in June to an almost negligible two percent this fall.

Clearly, borrowers have become aware of the dangers in taking loans that allow negative amortization and are overwhelmingly favoring ARM plans that do not allow the loan principal to increase.

Outlook for 1985

Will ARMs increase or decrease their market share in 1985? At this time the outcome is uncertain. Higher initial interest rates on ARMs and tighter underwriting procedures have increased the amount of income needed to qualify for an ARM. Under some conditions, this could lead to a decrease in home sales activity, with a smaller share being captured by ARMs On the other hand, the interest rate spread between FRMs and ARMs may not continue to narrow, but rather may rise if the general level of interest rates rises in 1985. Uncertainty about inflation, the Federal budget deficit, and the future growth rate of the economy are generating many different forecasts of interest rates. If interest rates rise in 1985, ARMs are likely to retain their current market share with perhaps a modest increase. However, if interest rates decline or remain stable, ARMs probably wil continue to lose some of their appeal to homebuyers.

CHARACTERISTICS OF ADJUSTABLE RATE MORTGAGES
(Percentage Distribution)

	October 1984	June 1984
Interest Rate Index		
U.S. Treasury Securities	68	64
6 Month Bill	12	10
One Year Note	72	77
Three Year Note	13	11
Five Year Note	3	2
FHLBB Contract Rate	12	22
Average Cost of Funds	18	9
Other	2	5
	100	100
Payment Adjustment Period		
6 Months or Less	5	4
One Year	74	76
Three Years	18	16
Five Years	2	3
Other	0	1
	100	100
Use of Borrower Protection Cap(s)		
Both Adjustment Period and Life of the Loan Caps	88	79
No Cap of any Kind	4	13
Adjustment Period Caps Only	4	6
Life of the Loan Caps Only	4	2
	100	100
Extent of Negative Amortization		
No Negative Amortization	91	85
Restricted Negative Amortization — 125% of Loan Amount	7	8
Unrestricted Negative Amortization	2	7
	100	100

ATTACHMENT B

NARRATIVE DESCRIPTION

REALTOR PROPOSED ARMs MODEL DISCLOSURE FORMAT

Purpose

Current disclosure requirements differ widely among the three regulators -- the Federal Reserve Board, the Federal Home Loan Bank Board, and the Office of the Comptroller of the Currency. To simplify the existing requirements, avoid consumer confusion, and to improve/strengthen disclosure requirements, the NATIONAL ASSOCIATION OF REALTORS strongly favors and urges the adoption of a uniform disclosure format. This format and its requirements would be used by all lenders and supervised by all regulators. In this way, consumers shopping for a loan can compare the ARM program offered by different lenders on a consistent basis.

NAR recommends that any Uniform ARMs Disclosure Format contain the following provisions:

1. Assumability - Description of the assumption features of the instrument, the specific terms of its assumability/transferability, and any associated prepayment penalties.
2. Index - Identification of the interest rate index, source of publication, and availability. Disclosure of the expectation of the index's performance for the 5 year period used in the scenario below.
3. Rate and Payment Limitations - Description of rate or payment limitations, if any. If there are no limitations on the amount by which the loan balance, interest rate, or monthly payments may change from one adjustment period to the next or over the life of the loan, full disclosure of that fact(s) must be provided in clear and conspicuous language.
4. Carryover Features - If the instrument permits interest rate adjustment carryover, description of how the carryover of previously unapplied interest rate changes in the index could affect payment adjustments, including how the mortgage contract interest rate can change: (1) in the opposite direction from an index adjustment, and (2) where no change occurs in the index value.
5. Negative Amortization - If the instrument permits negative amortization, a statement that this feature can mean lost equity for the homeowner. If there are limitations on the maximum amount of negative amortization which can accrue, a statement of that fact and of the consequences of such a situation.
6. Margin/Spread/Basis Points - Identify the amount of the margin/spread/basis points.
7. Contract Interest Rate - Explanation of how the contract interest rate is initially calculated and later adjusted using the interest rate index plus the margin/spread/basis points, and how they relate to the initial rate.

8. Lifetime Cap - (yes) (no), if yes, indicate what rate the lifetime cap is predicated upon (initial, note, or accrual).

9. Recasting Provision - If the instrument permits recasting of the loan once any specified limitations have been reached (resulting in changes in the loan balance, APR, or monthly payments), or when recasting will automatically occur, full disclosure of that fact and of the methods of calculating those changes.

10. Rate and Payment Adjustments - An explanation of the rate upon which future rate/payment adjustments are made (i.e., initial rate, note rate, accrual rate). Advance notice (30-120 days) of rate or payment adjustment.

11. Fees - A listing and explanation of any fees relating to late payment, insurance, and prepayment (see assumability).

12. "Projection Scenario" - A hypothetical payment schedule which demonstrates what the maximum changes in monthly payments (in dollar amounts) would be for the next five (5) years under the mortgage terms negotiated. The hypothetical projection should:

    - show projection of amounts based on the frequency of adjustments in the specific loan instrument.
    - show the projection of negative amortization, if such a feature is included in the specific loan instrument.
    - show the effect of caps (payment or rate), if such limitations are included in the specific loan instrument.
    - show the effect of carryover of previously unapplied interest rate changes on projected payments, if this is a feature of the specific loan instrument.
    - for ARMs with an initial rate below the note rate include what will happen to the interest rate at the first adjustment, assuming the index stays the same, and what the resulting changes in monthly payments (dollar amounts) will be.

RELATED ARMs DISCLOSURE RECOMMENDATIONS

The following recommendations are made with regard to ARMs disclosure. Although they are not specifically included in the proposed Model Disclosure Format, they are linked to its implementation.

- Timing - Disclosure should occur on two separate occasions.

    1. At the time the borrower is "shopping" for a loan prior to commitment. Disclosure at this point should be generic to the loan program. This document should be signed and receipted from the potential borrower within the initial disclosure time period.
    2. At the acceptance of the loan commitment by the borrower (signing of the loan documents). Disclosure at this point should be specific to the loan's terms.

- Applicability - All lenders, regardless of which regulatory agency supervises them, will comply with the uniform disclosure requirements. No exemptions will be permitted.

- Advertising - Advertising should be "meaningful" and specific rules governing advertisement of discounted ARMs should be provided. Not only should the initial interest rate be shown, but the increase at the first adjustment should also be displayed.

Senator **Gorton**. Thank you for that model format.

I think the question I'm going to ask you, Ms. Caplan, is a little bit off the subject on which you've been discussing.

ELICITING FINANCIAL INFORMATION

It may be a little off the subject of this hearing but we have been informed that an increasing number of realtors have now adopted a practice of eliciting financial information from prospective home buyers to determine how large a loan they can afford. This is information which has traditionally gone to the lender but not to the realtor because the realtor represents the seller and not the home buyer.

There's been concern expressed that the bargaining position of the home buyer is impaired when the realtor knows exactly how much the buyer can afford.

Can you comment on that? Is that a practice which takes place in your market?

Ms. **Caplan**. In our area, it is quite common for a realtor to sit down, first of all, with a loan officer and prequalify their buyers to what they can afford. Many buyers will qualify for a 10-percent loan—let's say, maybe a $100,000 loan—but if they want the traditional 13-percent, 30-year fixed loan, maybe they can only qualify for a $65,000 loan.

So it is true that when the borrower and the realtor go out into the marketplace and shop for a loan——

Senator **Gorton**. Is this after they've decided what house to buy?

Ms. **Caplan**. This is prior to them going out and shopping.

Senator **Gorton**. Shopping for the loan or shopping for the house?

Ms. **Caplan**. Shopping for the house. In other words, we will as realtors, go out in the marketplace and actually state "You can afford a 10-percent loan at this amount or you can buy a more expensive home" giving the rate they chose. Does that explain?

Senator **Gorton**. That explains it but it doesn't answer the question as to whether or not soliciting this information before they begin to shop for the home gives the realtor and the seller a bargaining advantage that they wouldn't otherwise have.

Ms. **Caplan**. Thank you. I just had a nice comment from staff but I would like to speak from a practitioner's point of view.

As a seller of a property, any of us in this room that sell our homes, I think, want to know before we sign that deposit receipt, how qualified is the buyer? And that is a question that many sellers are asking. And if a realtor has prequalified their client, they usually do disclose that to the seller that this person can afford a mortgage of so much amount.

And I think disclosure is really becoming the name of the game and prequalifying is becoming essential because more sellers are asking that question if a new mortgage is going to be originated.

Senator **Gorton**. Ms. Meier, can you comment on that?

Ms. **Meier**. Senator, all I can say on that is in my experience, it is a prevalent practice. In fact, my parents are both real estate agents and I know that they suggested I get prequalified. It does, perhaps, give an advantage. I don't know that it's really an unfair advantage because I think the practitioners do need to know if they're dealing with a consumer who can afford the houses that the agent is showing them.

Senator GORTON. While you're speaking, would you comment on the various consumer booklets that we've seen and others which haven't been discussed in this hearing? Do they do a great deal of good for the consumer? Are they readable, understandable, and do they get them on time?

Ms. MEIER. Senator, I have most close knowledge of the one that was prepared by the Home Loan Bank Board and the Federal Reserve Board. In fact, I participated in its preparation.

Consumers Union declined from being listed as persons who consulted with the agencies in putting it together because we didn't think that some of the disclosures were stern enough or the explanations of the possibilities were stern enough.

However, in terms of simply educating the consumer as to the terminology and functionally how these instruments work, I think that that pamphlet does a pretty good job. And we would recommend that that general type of information regarding the nature of an adjustable rate mortgage, be provided at the time the application is provided to the borrower, so that not only will they have specific ARM information regarding that lender's specific instrument but this booklet which will allow them then to integrate all the information.

DEFAULT EXPERIENCE

Senator GORTON. Mr. Aylward, tell me about default experience with ARM's and how they compare with your experience over the years with fixed rate mortgages, if there is any difference, when it applies.

Mr. AYLWARD. We've not been able to find any greater incidence of default between ARM's and fixed rate loans in the last 3 years or so. Most defaults traditionally begin to occur the second year, they typically peak out in the fourth year.

Senator GORTON. Let me go back. Generally speaking, defaults, if they're going to occur, occur in the first couple of years?

Mr. AYLWARD. Default rates climb rapidly in the first 2 years, however default is related to loan to value for both ARM's and fixed rate loans. The highest ratio conventionally insured loans, 95 percent LTV, in general, are the highest risk. Actuarial tables based upon experience haven't been able to decide specific default comparisons between ARM's and fixed rate but such studies are underway.

MICA hired an outside consulting firm about a year ago to study the industry especially as to the new risks the industry is facing. In a study at my company based upon our data. We found out that almost 100 percent of the losses came from less than 20 percent of our customers, and we're reaching the conclusion that this concentration of bad lenders is something we need to investigate.

All of our customers are generally using ARM's and fixed rate. Thus, the results that seem to determine bad lenders has something to do with the disclosure we're talking about here now. It also has a lot to do with the servicing after we buy it. The industry has gotten to the point now where many loans are sold by the originator within 6 months, and the new servicer is 5,000 miles away. I was visiting a lender in West Virginia the other day, who was selling loans to a firm in El Paso, TX, and I said, "What does the new lender do when loans get delinquent?" "Well, we have a WATS line." But I said, "Who goes out and helps them?"

I think the quality of the lender's servicing and what they do with the borrower is as important as the instrument.

Senator GORTON. Thank you. One more for you.

What is being done, as far as you can tell, to correct the problem of the inflated appraisals?

Mr. AYLWARD. Very little. The two appraisal societies represent less than 5 percent of the appraisals. It is sort of the "tail wagging the dog."

Most lenders use appraisal forms so all their loans can be sold to FNMA and FHLMC, in the secondary market. Last year, of the $200 billion originations, $100 billion did go to FHLMC, FNMA, GNMA. So they, the agencies basically control appraisal standards. We are encouraging these agencies to require more detail on their forms about the specific homes that they're buying and about the three or four comparables used in the appraisal. Did the comparables have a buydown? You know, if there are three homes in the neighborhood and the builder spent $10,000 for a lender to buy them, you can buy it for $10,000 less in cash, and that's not been revealed. The total real estate industry, in my opinion, are begging FMNA and FHLMC to require the forms we need. These agencies are the only ones that are strong enough to establish standards. They do not want to be regulatory agencies. You want to understand that, but I think they have the responsibility, because of their magnitude and, of course, quasi-government status—FNMA has a depreciated line of about $2 billion.

Senator GORTON. Thank you. The chairman's time has run out for this hearing. Both the chairmen and several of the other members of the committees, as you have heard, do have additional questions, which we will submit to you in writing. In addition, I am submitting for the record a study of real estate finance issues prepared by Mr. Gordon W. Schlicke of the Washington Mutual Savings Bank in Seattle, WA.

We appreciate the help each of you has given us in this oversight hearing.

With that, we adjourn.

[Whereupon, at 11:35 a.m., the joint meeting of the subcommittees was adjourned.]

[Response to written questions of the committee members follows:]

[Additional material supplied for the record follows:]

MORTGAGE INSURANCE COMPANIES OF AMERICA
1725 K STREET, N.W., SUITE 1405 — WASHINGTON, D.C. 20006 — (202) 785-0767

May 2, 1985

STEVEN P. DOEHLER
EXECUTIVE VICE PRESIDENT

Honorable Slade Gorton
United States Senate
Washington, D.C. 20510

Dear Senator Gorton:

The following is the response of Jim Aylward to your question concerning whether ARM issuers adequately consider a borrower's future creditworthiness given the possibility that his income may remain constant in the face of significant increases in his mortgage costs:

> Generally, most ARM lenders do properly underwrite a borrower's credit. However, your question accurately points out that in addition to the typical credit underwriting, ARM loan underwriting must take into consideration the unstable payment schedules and unpredictable future payments. The underwriting of an ARM borrower should evaluate whether the characteristics of the loan (payment caps, rate adjustment, prepayment rules etc.) are compatible with a borrower's likely ability to repay.
>
> Loans with variable rates obviously have more risk for borrowers than do fixed rate loans. However, adjustable rate loans are not necessarily less advantageous for borrowers, nor should good ARM's necessarily mean tighter underwriting ratios for approval. Anytime a borrower enters the market there is the possibility that rates in the future may fall as well as rise. In fact, fixed rate loans with refinancing costs prevent borrowers from benefitting as rates fall, an obvious disadvantage that these loans have over ARMs.
>
> The changes that have occurred in housing finance including the influence from a slowing in home price appreciation, affect consumer risk. The methods of underwriting ARM borrowers is far less a potential

consumer problem than are the demonstrated abusive practices that are occurring, including unsound financing terms (such as excessive buydowns), inflated appraisals and poor loan servicing. Unfortunately these practices are likely to cause serious consumer problems if not corrected.

We appreciate the opportunity to have participated in this important hearing.

Sincerely,

SPI:cd

STATEMENT
OF
THE AMERICAN BANKERS ASSOCIATION

We would like to thank you for this opportunity to present the views of the American Bankers Association on adjustable rate mortgages (ARM). The combined assets of our members comprise approximately 95 percent of the industry total. While our members range in size from the smallest to the largest banks, approximately 85 percent of them have assets of less than $100 million.

We would like to discuss three areas of concern in relation to these mortgages. First, the reasons for development and continuing necessity of adjustable rate mortgages; second, the adequacy of the current regulations applicable to banks and other mortgage lenders in regard to adjustable rate mortgages; and third, consumers difficulties with adjustable rate mortgages.

The Necessity of Adjustable Rate Mortgages

Adjustable rate mortgages were developed and are being originated today because changes in market conditions have made it economically impossible for mortgage lending institutions to accommodate their customers using fixed rate mortgages while maintaining the safety and soundness of their institution. Since the late 1970s, there has been increased volatility in interest rates coupled with a prolonged rise in the level of rates since the mid 1960s. This volatility in rates and therefore in lenders' cost of funds has resulted in serious operating losses and erosion of net worth for many mortgage lending institutions which had portfolios of long term fixed rate mortgages financed by short-term variable rate deposits.

Therefore, changes in the capital markets have brought about the need for interest sensitive mortgage loans. Previously, banks and thrifts provided the major conduit for most consumers to invest their savings. These savings dollars were deposited for the most part in federally regulated and interest rate capped savings accounts which, in turn, provided the primary pool of funds from which financial institutions drew upon to finance mortgage loans. The deregulation of the liability side of the balance sheets of banks and thrifts, the increased competition from nonbank competitors, such as money market funds, and the volatility of interest rates has required a change in the lending policies under which lenders operate. Banks and thrifts have, of necessity, started to sell loans in the secondary mortgage market and originate adjustable rate mortgages for their own portfolios.

The secondary mortgage market gives lenders the opportunity to meet customer demand for home mortgages and maintain desired portfolio balance by selling off those loans that do not fit their portfolio. Additionally, adjustable rate mortgages allow lenders to offer loans at a lower rate by sharing the interest rate risk with borrowers.

Adjustable rate mortgages are necessary in the mortgage market given present economic conditions. Any regulations that prevent or restrict lending institutions from using adjustable rate mortgages would be detrimental to the homebuyer. Money would most likely be available only through fixed rate mortgages at rates that would make it impossible for many individuals to purchase a home. However, the advantages of adjustable rate mortgages would decrease for a financial institution if interest rates returned to a lower level and remained steady. If this happened, the interest rate risk an institution takes when holding a fixed rate mortgage would decrease and the rate differential between the adjustable rate mortgage and the fixed rate mortgage would diminish.

Current Regulations and Disclosure of Adjustable Rate Mortgages

Customer acceptance of adjustable rate mortgages depends largely upon designing a product that will enable the knowledgeable consumer to assume interest rate risk in a manageable form. This will occur if lenders have the freedom to design an attractive product and the consumer is aware of all the implications of the adjustable rate mortgages. The obvious unknown will always be the future interest rate environment. However, as consumers are educated in the benefits as well as the risks involved in adjustable rate lending, they are accepting ARMs much more readily. Through consumer education and information disclosure, lenders can substantially decrease future payment concerns often referred to as "payment shock".

Current adjustable rate mortgage disclosure regulations applicable to commercial banks are probably the toughest in the industry and help to assure that a consumer has full awareness of the agreement entered into when the mortgage is signed. On March 27, 1981, the Office of the Comptroller of the Currency (OCC) issued a regulation allowing national banks to make adjustable rate mortgage loans. The regulation was revolutionary in that (1) it gave national banks a mortgage instrument that enabled them to more closely match assets and liabilities, and (2) the regulation established guidelines and limitations within which individual banks could design instruments that they felt best met their own needs and the needs of their customers. To provide increased flexibility and stimulate further experimentation, the OCC issued a revised adjustable rate mortgage regulation on March 7, 1983.

The Comptroller's regulations contain requirements on disclosure that must be followed by national banks. Among the items that must be presented to the borrower in writing are (1) the fact that the interest rate may change and a brief description of the general nature of an adjustable rate mortgage loan, (2) the index used and the name of at least one readily available source in which it is published, (3) a 10-year historical series (or if a 10-year series of the index does not exist the longest available series) updated at least annually showing the values of the index on at least a semiannual basis, presented in a table. The table should show either single values, consistent with the bank's adjustable rate mortgage loan program, and (4) the frequency with which the interest rate and payment levels will be adjusted.

Additionally, a bank offering adjustable rate mortgages must disclose a schedule of the dollar amount of the installment payments (principal and interest) and the outstanding loan balance at each payment adjustment date on the adjustable rate mortgage loans assuming an initial loan balance of $10,000. The disclosure includes the rate index increases of one percent per six months for the first five years of the loan term and a constant interest rate index thereafter, and should cover the entire loan term.

In addition, the Federal Reserve, which implements the Truth-in-Lending Act, requires lenders to make a number of disclosures which give the consumer a very complete picture of the ramifications of the financing agreements he is entering. Section 226.18(f) of Regulation "Z" mandates disclosure in a variable rate transactions of (1) the circumstances under which the rate may increase, (2) any limitations on the increase, (3) the effect of an increase, and (4) an example of the payment terms that would result from an increase. It should also be noted, however, that institutions that are required to comply with the variable rate regulations of other federal agencies, may substitute the requirements of those regulations, for those of Regulation "Z". For instance, as previously mentioned, the Comptroller of the Currency has issued regulations governing the ability of national banks to make variable rate loans. These regulations would supersede the requirement of Regulation "Z". The Federal Home Loan Bank Board has also promulgated regulations for federally chartered savings institutions. If the disclosure requirements of these regulations differ from Regulation "Z", customers of these institutions may not receive the same information.

Further protection is offered under Regulation "Z" where the initial rate of a variable rate note is disclosed to be below what it otherwise would be based on the current level of the index. In this case, the disclosure to the consumer must reflect a composite annual percentage rate based on the lower discounted rate for as long as it is applicable and the balance of the term at the rate that would be applicable if the initial rate was calculated using the index. Thus, an ARM with a "teaser" rate will have a much higher annual percentage rate than the initial interest rate quoted, and consumers will not be misled as to the true cost of the loan.

We are making available to our members a handbook on adjustable rate mortgages for distribution to their borrowers. This booklet, the Consumer Handbook on Adjustable Rate Mortgages was developed jointly by the Federal Reserve and the Federal Home Loan Bank Board. The brochure represents an objective presentation of the risks involved in adjustable rate lending and emphasizes the borrower's responsibility to learn all that he can about adjustable rate mortgages before entering a contract.

We believe that the Comptroller's current disclosure regulations on adjustable rate mortgages are sufficient for the purpose of educating the consumer and that any problems that have been encountered have not been with lenders subject to the Comptroller's regulations. Lenders that want to remain in the business of originating ARMs, to hold in their portfolio or sell in the secondary market, must be willing to educate consumers as to the risks and benefits.

We support the concept of uniform ARMs disclosure applicable to all real estate lenders. Uniform disclosure would aid the consumer in evaluating different mortgage programs and enhance the development of the secondary market in adjustable rate mortgages. The Comptroller's regulations require that disclosure information must be presented on the earlier of the date on which the bank first provides written information concerning adjustable rate mortgage loans available from the bank or provides a loan application form to the prospective borrower. However, disclosure requirements affecting other lenders do not require these materials to be given at the time of the application. This makes it more difficult for a consumer to shop around for a mortgage. The Comptroller also requires that national banks purchase only loans which have followed OCC requirements. Loans which have not followed OCC requirements cannot be purchased by national banks in the secondary market. This hinders the development of the secondary market. Uniform disclosure would ease these problems.

Consumer Difficulties with Adjustable Rate Mortgages

There have been horror stories in the media relating to "teaser" or below market rates offered by the lender to attract business. We, in the commercial banking industry, are concerned about the effects this practice may ultimately have on the consumer should interest rates continue to rise substantially. The view of ABA is that qualifying prospective borrowers on the basis of a deep discounted rate rather than the base rate is risky business for both lenders and borrowers.

A homeowner faced with a monthly increase reflecting both the termination of the discount and an increase in the ARMs (index) may find the new payment unaffordable. This could result in an increase in delinquencies as interest rates rise. Educating the consumer will make him aware of the increase in payments resulting from interest rate rises or expiration of initial discounts on mortgages. Education cannot, however, completely prepare the borrower for unexpected increases in payments due to unforeseen interest rate increases.

Conclusion

Adjustable rate mortgages fill a need in the marketplace. Although originally designed to protect lenders in a high interest rate environment, use of the ARM instrument should not subside during periods of temporary low interest rates. A prudent lender will want to originate different types of mortgages -- a mix of which will protect that institution should high interest rates return. Educated consumers will be able to "shop around" and choose a mortgage that is tailored to their specific needs.

We believe that the Comptroller's current disclosure regulations on adjustable rate mortgages are sufficient for the purpose of educating the consumer. More stringent regulations will provide little additional protection to the consumer. Uniform regulations will, however, aid the consumer in shopping for a mortgage and will enhance the development of a secondary market in ARMs.

Finally, the only sure way of alleviating consumer concerns about ARMs is to modify the volatile high interest rate environment that creates those concerns. If we can reduce the federal budget deficit, we will have taken the first step towards providing the kind of long-term economic stabilization that benefits both industry and consumers.

Adjustable Rate Mortgages: Recent Experience and Ongoing Problems

on behalf of the
California Association of REALTORS®
before the Senate Subcommittees on Financial
Institutions and the
Housing and Urban Affairs

Raymond D. Spinelli, President

April 19, 1985

This testimony is submitted by the California Association of REALTORS® for consideration during the upcoming joint hearings before the Senate Subcommittees on Financial Institutions and Housing and Urban Affairs with regard to adjustable rate mortgages (ARMs). The California Association of REALTORS® is a trade organization representing 103,000 real estate licensess in the state of California whose business transactions involve assisting buyers and sellers in locating alternative sources of real estate financing.

When the Subcommittee on Housing and Community Development of the House Banking, Finance and Urban Affairs Committee held hearings on adjustable rate mortgages last June, the Association submitted testimony on both the real and potential problems with these instruments and the need for specific steps to ensure adequate consumer protection. We called on allied industry groups to become involved in efforts to educate the public on ARMs and on the Congress and regulatory agencies to both extend current advertising and disclosure requirements and tighten enforcement efforts. During the past year many groups, including my own organization, have launched information campaigns designed to make potential borrowers aware of both the advantages and disadvantages of ARMs. Perhaps the most visable result has been the recent publication of a consumer handbook on ARMs developed by an industry-wide task force appointed by Congress last summer. However, the three agencies resposible for overseeing these instruments and the lenders who provide them, the Federal Reserve Board, the Federal Home Loan Bank Board and the Office of the Comptroller of the Currency, have not, in the Association's opinion, taken all of the actions necessary to ensure that consumers are adequately protected. Many of the problems and concerns expressed during last years' hearings remain. In particular, our Association wishes to direct your attention to the following issues:

1. **Lack of Standardization** - Required disclosures are not standardized among the various lenders, making it difficult if not impossible for consumers to compare the benefits and risks associated with different ARM programs.

2. **Technical Language/Examples** - Many disclosures continue to be written in highly technical and confusing language and often fail to contain an easy to understand numerical example.

3. **Inadequate Timing of Disclosures** - Disclosures are often provided too late in the loan application process (after the loan application fee has been paid) to be useful to the borrower.

4. **Teaser Rates and Payments Shock** - Deeply discounted initial rate ARMs continue to be offered by many lenders without adequate explanation of the extent of the possible payment increase at the time of the first adjustment. Misleading advertisements have contributed to the incidence of "payment shock" where homeowners are hit with unexpected increases in their monthly payments at the time of adjustment.

5. **Miscalculation of Annual Percentage Rates (APR)** - In advertisements lenders are required to state the initial rate and the APR over the life of the loan. Although the correct procedure for calculating the APR is specified in Regulation Z (Truth-in-Lending), it is apparent from advertisements that the APR in many cases miscalculated, using only the initial discounted interest rate, thus skewing the APR downward.

6. **Constrained Assumability** - Frequently advertisements claim full assumability of an ARM upon resale, but fail to inform consumers that at the time of assumption adjustments will be made to the interest rate caps and that the new buyer must be fully reviewed and qualified by the lender.

7. **Miscalculation of Payment Adjustments** -There are increasing reports of ARM payment adjustments that have been incorrectly calculated, usually resulting in an overpayment by the borrower.

8. **Incorrect Accounting Procedures** -ARMs which permit negative amortization many include a provision that allows the borrower to avoid additions to principal by increasing the monthly payment. In practice, the amount by which the monthly payment is increased is in many instances being treated as a payment to principal instead of interest, reducing the amount of the mortgage interest deduction that can be claimed for tax purposes.

Other Issues

9. **Proposed Changes To FHA-ARM Program** -Last July HUD announced its own FHA-ARM program that contained many consumer protection features. HUD is now considering asking Congress to raise the annual rate cap from one to two percent, requiring stricter underwriting criteria which will reduce its ability to serve first-time buyers and setting an unfortunate example for the rest of the industry.

10. **Lender Assessment of Prepayment Penalties On Loan Acceleration** -On a related issue, the legislative intent of Congress as related to the imposition of prepayment penalties in conjunction with mortgage loan accelerations has been thwarted. The Federal Home Bank Board has as yet not taken appropriate action to protect consumers from these inappropriate charges.

In order to address these problems the efforts already undertaken to educate borrowers, lenders, and the general public about adjustable rate mortgage instruments must be continued. But, in addition, the

Association **strongly urges Congress and the regulatory agencies to take further actions necessary to:**

1. Standardize ARM disclosure requirements among all types of lenders;
2. Require that disclosures provide numerical examples that the consumer can use to compare the monthly payments of a mortgage instrument over the life of the loan. These examples should use interest rate scenarios that are standard among all types of lenders, and should include a "worst-case" scenario.
3. Require that disclosures be provided as early in the loan search process as possible, well before loan application fees have been paid. To ensure that consumers are given sufficient information before they make their loan decision this information should be given out to consumers at the time they first inquire about a loan;
4. Ensure stricter enforcement of Regulation Z, particularly the advertising practices requirements, and the calculation of the APR;
5. Require that advertisements specify the initial rate, the rate at first adjustment, and the APR; and
6. Increase regulatory policing of developing problems in ARM loan administration and servicing.
7. Prohibit the imposition of prepayment penalties when a due-on-sale clause is enforced.

The problems associated with ARMs that are of particular concern to the Association outlined above are discussed in greater detail below. The issues fall under three major headings; Disclosure/Advertising Practices, ARM Servicing/Loan Administration and Other Issues. In addition, we briefly discuss the impact that adjustable rate mortgages have had on the financial services industry and on consumers.

Disclosure /Advertising Practices

Standardization - The disclosures provided on many ARMs continue to be written in language that contributes little to consumer understanding. Fraudulent disclosures and violations of existing regulations concerning advertising continue to be reported, creating a situation where consumers are inadequately or even misinformed as to the nature of the financial obligation they are purchasing. While the provisions pertaining to disclosure appear clear, confusion among lenders persists because the three federal agencies with the authority to regulate lenders (the Federal Reserve Board through Regulation Z, the Federal Home Loan Bank Board and the Controller of the Currency,) each have their own ARM disclosure requirements. For example, savings and loans are not required to give consumers examples of how their mortgage would perform over time under different interest rate scenarios and those that the banks are required to prepare for consumers do not necessarily have to include the effect of an initially discounted mortgage interest rate. **A single, uniform set of disclosure requirements and format is needed to reduce this confusion** on the part of lenders and to provide consumers with the information necessary to compare different lenders' loans and make an informed decision.

Timing - In addition, the disclosure should be presented early in the loan search process, preferably at the time the consumer first inquires about ARMS. Currently, each agency has a different requirement regarding the time that the written disclosure be made available to the potential borrower. For example, the FHLBB requires that the written disclosure be made within three days after the written loan application has been made. By this time, however, the borrower has already made the decision on which loan to choose and has paid loan application fees. Thus, the written disclosure will not have been provided early enough to ensure that the consumer has fully understood and compared alternative mortgage instruments.

Teaser Rates - Last year, when adjustable rate mortgages were still relatively new, many lenders offered deeply discounted initial rates to attract potential borrowers by guaranteeing a below-market rate of interest for the first 6 to 12 months. Borrowers were able to qualify for loans at the low initial rates, enabling many borrowers to purchase homes that, without the discounted ARM, they would be unable to afford. Advertising focused on the low initial rate but typically did not provide information on the maximum potential payment increase at the time of the first adjustment, when the teaser rate was set to expire. This created a situation where consumers were purchasing ARMs without full knowledge of the potential impact on their future financial situation, thereby setting the stage for "payment shock". The prevelance of deeply discounted ARMs sold in 1983 and early 1984 has been credited by some observors with contributing to the above-average rate of home foreclosures during the second half of 1984. This connection will continue to be a concern as long as discounted ARMs are sold to marginally qualified and inadequately informed borrowers.

Contrary to public statements by some industry groups, teaser rates are still widely available in the marketplace today. One California thrift executive recently stated that "... virtually all of the attacks made on ARMs concerned themselves with teaser rates, and in California at least, these have pretty well gone down the drain--at least they are not being used very much by institutional lenders." But, information on initial ARM rates and APRs (which most closely approximate the interest rates that will be in effect at the time of first adjustment) printed in the Los Angeles Times tells a different story. Between August 1984 and March 1985, over 60 percent of the 22 savings and loans listed **increased the spread between their introductory rate and the APR,** implying even larger discounting of rates. In almost all cases the spread exceeded one percentage point with one institution offering a nearly four percentage point spread! (see attachment)

Annual Percentage Rate - Regulation Z requires that in advertisements the annual percentage rate (APR) must be given if a simple interest rate is quoted. When a "teaser rate" is involved, the APR must be calculated based **both** on the initial "teaser" rate and the indexed rate (index + spread) in effect at the time the loan is made. However, inaccurate calculation of the annual percentage rate contiues to be a widespread occurance, particularly with the discounted-ARMs. Many of the rates being published in advertisments and weekly comparative charts in newspapers are calculated incorrectly using only the "teaser rate". For example, one Southern California newspaper publishes data on ARMs provided by a firm that calculates the APR using only the initial rate and points charged by the lender. The spread between the initial rate and the APR is less than 30 basis points for all of the lenders included in the survey, when in fact the true differential is typically in excess of 100 basis points.

Assumability - Advertisments of ARMs have frequently claimed full assumability upon resale, implying advantages for consumers who choose ARMs over fixed rate loans. In California, assumable loans are much sought after as a result of the publicity around the assumability issue in the last four to five years. More frequently than not, however, at the time of assumption, adjustments are made to the lifetime interest rate cap and index that can, in effect, remove any advantage of assumability. In addition, the new buyer must be reviewed and qualified by the lender.

The Federal Reserve Board has just issued final changes to the Official Staff Commentary interpreting Regulation Z specifically with regard to assumption policies. The new language would require lender disclosures to "reflect" any "uncertainty as to the assumability of the obligation." While helpful, this language is substantially less stringent than earlier proposed. The FRB had initially proposed that lenders be required to "state that the obligation cannot be assumed on its original terms", if applicable and classify obligations that are subject to a due-on-sale clause as "non-assumable". We are not clear why the FRB chose to soften the advertising disclosure requirements with respect to assumability, but the revised language is more to the disadvantage of consumers, in the Association's opinion.

ARM Servicing/Loan Administration

Payment Adjustments - The increasing experience with adjustable rate instruments, particularly as the discounted ARMs purchased six months to one year ago have reached the first interest and/or payment adjustment, has revealed several problems specifically associated with the administration of these loans. For example, there have been reports of miscalculated payment adjustments usually resulting in an over-payment by the borrower. While some borrowers are sophisticated enough to double check lenders' adjustments by adding the spread to the index which is readily available from the Federal Home Loan Bank Board (Cost of funds) or the Treasury (T-bills), others are not. In the first case, the borrower faces the inconvenience of notifying the lender of the error. In the second case, the borrower ends up paying more than is necessary.

Negative Amortization - Another area of concern involves the servicing and administration of loans that permit negative amortization whenever an interest rate increase would require a payment adjustment in excess of the payment cap. In this instance these loans allow some or all of the added interest due to be added to the principal balance of the loan. In California, for example, the majority of loan programs offer an annual 7.5 percent payment cap, which in the absence of annual interest caps, results in negative amortization when the interest rate is adjusted upward by more than one percent. Often these ARMs are marketed with the assurance that additions to principal can be avoided if the borrower, in effect, nullifies the payment cap and increases their monthly payment by the amount necessary to cover the higher interest rate at the time of adjustment. What appears to be happening, however, is that after the higher payment is received by the lender, the amount paid in excess of the 7.5 percent payment cap is being credited entirely to principal and not as a payment of interest. As a result, at year-end borrower will be credited with having paid less than the interest actually incurred, reducing their mortgage interest deductions to their disadvantage.

Other Issues

Proposed changes to FHA ARM - In July, HUD attempted to create an industry-wide standard by initiating its own FHA-ARM program. The Association applauded this instrument's design because it contained features which we believed would protect consumers, including a 1 percent annual interest cap, a 5 percent lifetime cap and no negative amorization. HUD is now considering requesting that Congress raise the annual rate caps on FHA-insured ARMs from 1 percent to 2 percent while retaining the 5 percent lifetime cap.

HUD admits that such a move would require stricter underwriting standards **because many FHA homebuyers would be unable to afford an annual 2 percent rate increase.** This would prevent many first-time buyers from obtaining FHA-insured ARMs, and represents a retreat from the strong consumer protection stance initially taken by HUD. HUD's influence as an industry standard-bearer should be used to promote the safety of these instruments, especially for first-time buyers.

Lender assessment of prepayment penalties on loan acceleration - Lenders are ignoring the spirit, if not the letter of 12 CFR Part 591.5 which became effective July 13, 1983. That regulation prohibits the imposition of prepayment penalty fees by lenders in conjunction with the exercise of a due-on-sale clause. Since that time, **lenders have been claiming that a simple "refusal" to permit an assumption which has the effect of forcing repayment of the existing financing, is not an "acceleration" contemplated by the regulation,** and therefore does not trigger the prohibition on charging prepayment penalty fees. Lenders reason that since they have not filed a notice of default to enforce a due-on-sale provision, they can charge a prepayment fee. In effect, consumers experience a "double whammy": the loan is not assumable and the lender charges a prepayment penalty. In August 1984, the FHLBB issued proposed regulations to prevent these abuses, establishing a 30-day comment period at that time. Then, following months of delay, in late November the regulatory comment period was extended for 60 days. At this time, **final regulations have still not been issued.** The Association urges Congress to seek a meaningful solution to this problem.

Implications for the Financial Industry

The impact of the phenomenal growth of ARMs in the last two years has been felt throughout the financial services industry. Perhaps the most directly affected group has been the mortgage insurance industry which is responsible for insuring lenders against losses incurred as a result of defaults and foreclosures. There has been a significant increase in mortgage loan foreclosures in recent years, from an industry-wide average of less than 1.0 percent in 1980 to over 1.5 percent in 1984. The fact that foreclosures have continued at high level in spite of a well-established economic recovery suggests that factors other than the 1981-1982 recession are responsible. And the mortgage insurers clearly believe that ARMs are one of the problems, ranking ARMs from two to three times more risky than fixed rate loans. In October, MGIC, the nation's largest insurer, announced its intention to charge 60 percent more in monthly payments for coverage on an ARM - a difference of about $8 a month on a $65,000 mortgage. Many mortgage insurance companies have also significantly tightened their underwriting standards and even refuse to insure ARMs with initial period discounts in excess of an established threshold.

At a recent meeting of the Mortgage Bankers Association meetings the regional Vice-President of Foremost Guaranty Corp., Neil Moser, raised the spector of "portfolio default". The possibility of widespread simultaneous default exists today with a large number of loans reaching an adjustment date at the same time. According to Mr. Moser, the occurance of widespread payment shock and ultimate default is a problem not of the future but of today. In addition, the lower rates of price appreciation now being experienced in many parts of the country tend to reduce any incentive a borrower who has been hit with payment shock might have to maintain payments.

Lenders who originate these loans are enccuntering unexpected ARMs-related expenses because these instruments require much greater servicing than their fixed rate counterparts. Keeping track of the indexes, changing rates and payments, notifying borrowers, and collecting payments are turning out to be complicated and expensive procedures for lenders with large portfolios of heterogeneous ARMs. The complexity of many ARM programs also generates consumer confusion and questions. One lender reported that ARMs made up only 15 percent of his company's portfolio but were responsible for 40 percent of the calls received by the customer service department. There costs reduce the lender's profit-margins, making ARMs more expensive.

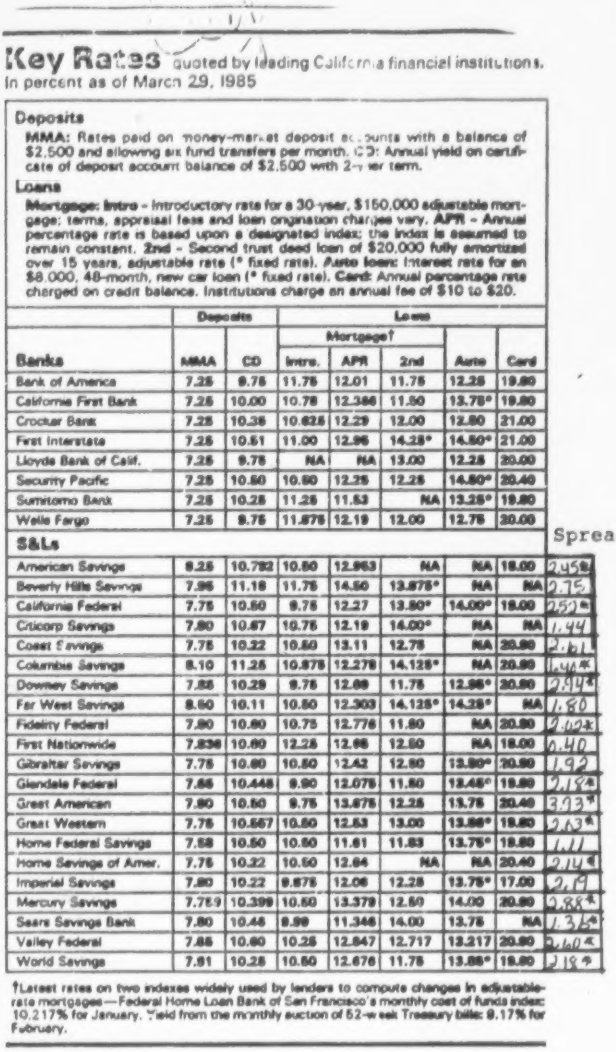
Efforts to establish a standard ARM that would enable these instruments to be securitized and traded in the secondary market have not been successful, in part because of a lack of direction from federal regulators. Until an ARM is developed that contains a combination of features that makes it attractive to borrowers, lenders and investors, the developmemt of a secondary market in ARMs will be hindered The absence of this market not only forces lenders to hold onto ARMs even when such a policy is not consistent with good portfolio management, but prevents the optimal redistribution of credit within the country.

Implications for Consumers

Consumers have been the recipients of both the added flexibility provided by adjustable rate instruments as well as the added risks. ARMs have permitted many households to qualify to purchase homes that, without the ARM financing, they would otherwise have been unable to purchase. And many of the households who have financed homes with ARMs in the last two years have been satisfied with them. But, as detailed above, numerous problems remain. Inadequate disclosures that often do not contain a numerical example illustrating the relationship between changes in the index and changes in the monthly payment have meant that many consumers are completly unprepared for their first payment increase. Marginally qualifying households have in some cases experienced such large unanticipated payment increases that the result has been late payments and even default. In fact, the continuation of high foreclosure rates in a period of generally strong economic conditions suggests that ARMs sold to households who qualified only on the basis of a low initial rate are not viable in the long run.

Conclusions

Adjustable rate mortgages are an important and necessary financial instrument in today's rapidly changing economy and there is every indication that they will be a force in the market for quite some time. However, the ongoing problems associated with the advertising, disclosure, and administration of adjustable rate mortgages need to be addressed and corrected. The steps suggested by the California Association of REALTORS® in this testimony would help to ensure that the future evolution of ARMs proceeds in a manner that protects both borrowers as well as lenders from unanticipated costs, risks, and foreclosures. We hope that the Sub-committees will see fit to instruct the regulatory agencies involved to adopt the standards we suggest.



Key Rates quoted by leading California financial institutions.

In percent as of March 29, 1985

Deposits

MMA: Rates paid on money-market deposit accounts with a balance of $2,500 and allowing six fund transfers per month. **CD:** Annual yield on certificate of deposit account balance of $2,500 with 2-year term.

Loans

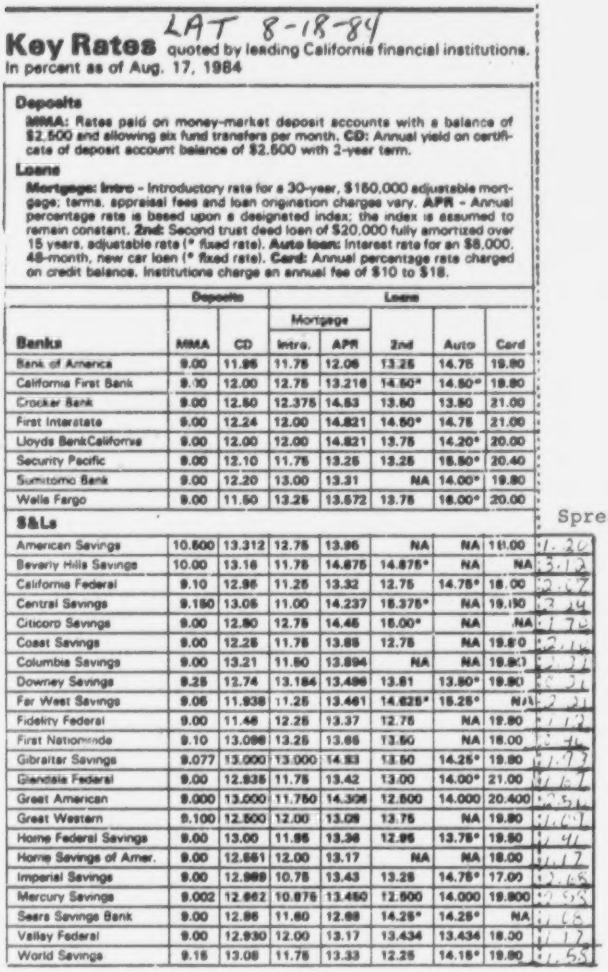
Mortgage: Intro - Introductory rate for a 30-year, $150,000 adjustable mortgage; terms, appraisal fees and loan origination charges vary. **APR** - Annual percentage rate is based upon a designated index; the index is assumed to remain constant. **2nd** - Second trust deed loan of $20,000 fully amortized over 15 years, adjustable rate (* fixed rate). *Auto loan:* Interest rate for an $8,000, 48-month, new car loan (* fixed rate). **Card:** Annual percentage rate charged on credit balance. Institutions charge an annual fee of $10 to $20.

	Deposits		Loans					
			Mortgage†					
Banks	MMA	CD	Intro.	APR	2nd	Auto	Card	
Bank of America	7.25	9.75	11.75	12.01	11.75	12.25	19.80	
California First Bank	7.25	10.00	10.75	12.386	11.50	13.75*	19.80	
Crocker Bank	7.25	10.35	10.625	12.29	12.00	12.50	21.00	
First Interstate	7.25	10.51	11.00	12.95	14.25*	14.50*	21.00	
Lloyds Bank of Calif.	7.25	9.75	NA	NA	13.00	12.25	20.00	
Security Pacific	7.25	10.50	10.50	12.25	12.25	14.50*	20.40	
Sumitomo Bank	7.25	10.25	11.25	11.53	NA	13.25*	19.80	
Wells Fargo	7.25	9.75	11.875	12.19	12.00	12.75	20.00	
S&Ls								Spread**
American Savings	8.25	10.782	10.50	12.953	NA	NA	18.00	2.45*
Beverly Hills Savings	7.95	11.18	11.75	14.50	13.875*	NA	NA	2.75
California Federal	7.75	10.50	9.75	12.27	13.50*	14.00*	18.00	2.52*
Citicorp Savings	7.80	10.67	10.75	12.19	14.00*	NA	NA	1.44
Coast Savings	7.75	10.22	10.50	13.11	12.75	NA	20.80	2.61
Columbia Savings	8.10	11.25	10.875	12.279	14.125*	NA	20.80	1.40*
Downey Savings	7.85	10.29	9.75	12.69	11.75	12.95*	20.80	2.94*
Far West Savings	8.50	10.11	10.50	12.303	14.125*	14.25*	NA	1.80
Fidelity Federal	7.80	10.60	10.75	12.776	11.50	NA	20.80	2.02*
First Nationwide	7.836	10.60	12.25	12.65	12.50	NA	18.00	0.40
Gibraltar Savings	7.75	10.60	10.50	12.42	12.50	13.50*	20.80	1.92
Glendale Federal	7.65	10.448	9.90	12.075	11.50	13.45*	19.80	2.18*
Great American	7.80	10.50	9.75	13.675	12.25	13.75	20.40	3.93*
Great Western	7.75	10.557	10.50	12.53	13.00	13.88*	19.80	2.03*
Home Federal Savings	7.58	10.50	10.50	11.61	11.83	13.75*	19.80	1.11
Home Savings of Amer.	7.75	10.22	10.50	12.64	NA	NA	20.40	2.14*
Imperial Savings	7.80	10.22	9.875	12.06	12.25	13.75*	17.00	2.19
Mercury Savings	7.759	10.399	10.50	13.379	12.50	14.00	20.80	2.88*
Sears Savings Bank	7.80	10.45	9.99	11.345	14.00	13.75	NA	1.36*
Valley Federal	7.85	10.60	10.25	12.847	12.717	13.217	20.80	2.60*
World Savings	7.81	10.25	10.50	12.676	11.75	13.88*	19.80	2.18*

†Latest rates on two indexes widely used by lenders to compute changes in adjustable-rate mortgages—Federal Home Loan Bank of San Francisco's monthly cost of funds index: 10.217% for January. Yield from the monthly auction of 52-week Treasury bills: 9.17% for February.

* Institutions who have increased the spread between the introductory rate and the APR over the period August 1984 to March 1985.

** APR less introductory rate.



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Key Rates quoted by leading California financial institutions.

In percent as of Aug. 17, 1984

Deposits

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Loans

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			Mortgage					
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California First Bank	9.10	12.00	12.75	13.216	14.50*	14.50*	19.80	
Crocker Bank	9.00	12.50	12.375	14.53	13.50	13.50	21.00	
First Interstate	9.00	12.24	12.00	14.821	14.50*	14.75	21.00	
Lloyds BankCalifornia	9.00	12.00	12.00	14.821	13.75	14.20*	20.00	
Security Pacific	9.00	12.10	11.75	13.25	13.25	15.50*	20.40	
Sumitomo Bank	9.00	12.20	13.00	13.31	NA	14.00*	19.80	
Wells Fargo	9.00	11.50	13.25	13.572	13.75	16.00*	20.00	
S&Ls								Spread
American Savings	10.500	13.312	12.75	13.96	NA	NA	18.00	1.20
Beverly Hills Savings	10.00	13.16	11.75	14.875	14.875*	NA	NA	3.12
California Federal	9.10	12.95	11.25	13.32	12.75	14.75*	18.00	2.07
Central Savings	9.150	13.05	11.00	14.237	15.375*	NA	19.150	3.24
Citicorp Savings	9.00	12.80	12.75	14.45	15.00*	NA	NA	1.70
Coast Savings	9.00	12.25	11.75	13.88	12.75	NA	19.80	2.13
Columbia Savings	9.00	13.21	11.50	13.894	NA	NA	19.80	2.39
Downey Savings	9.25	12.74	13.184	13.496	13.81	13.50*	19.80	.31
Far West Savings	9.05	11.938	11.25	13.461	14.625*	15.25*	NA	2.21
Fidelity Federal	9.00	11.45	12.25	13.37	12.75	NA	19.80	1.12
First Nationwide	9.10	13.098	13.25	13.66	13.50	NA	18.00	.41
Gibraltar Savings	9.077	13.000	13.000	14.73	13.50	14.25*	19.80	1.73
Glendale Federal	9.00	12.835	11.75	13.42	13.00	14.00*	21.00	1.67
Great American	9.000	13.000	11.750	14.306	12.500	14.000	20.400	2.56
Great Western	9.100	12.500	12.00	13.08	13.75	NA	19.80	1.08
Home Federal Savings	9.00	13.00	11.95	13.36	12.95	13.75*	19.50	1.41
Home Savings of Amer.	9.00	12.661	12.00	13.17	NA	NA	18.00	1.17
Imperial Savings	9.00	12.989	10.75	13.43	13.25	14.75*	17.00	2.68
Mercury Savings	9.002	12.862	10.875	13.450	12.500	14.000	19.800	2.58
Sears Savings Bank	9.00	12.86	11.60	12.68	14.25*	14.25*	NA	1.08
Valley Federal	9.00	12.930	12.00	13.17	13.434	13.434	18.00	1.17
World Savings	9.15	13.08	11.75	13.33	12.25	14.15*	19.80	1.55

REAL ESTATE FINANCE ISSUES

BY

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WASHINGTON MUTUAL SAVINGS BANK

Seattle, Washington

June 1985

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INTRODUCTION

Never has mortgage lending accommodated more change than now. A time-honored security device, the mortgage, has undergone more change in the last five years than in past decades. And the transformation is not yet complete. Borrowing money to build, buy or refinance your home has become a complex exercise.

While it may not be difficult to understand the concept of an interest rate that adjusts, today's issue is: How do I know I've made the best possible deal? The truth is that the best possible loan for you in nearly every case must be constructed according to your circumstance.

It is no longer true that the best deal is the lowest rate, longest term, best fee quoted. A whole spectrum of new loans is available. At this writing, mortgage loan closings are about evenly divided between fixed and adjustable rate products.

This paper examines components of adjustable rate mortgages (ARM's) and makes recommendations for borrowers attempting to design financing to their needs. Before we look at borrowing from the consumer's point of view, it is necessary to examine some of the considerations lenders make before committing to invest in mortgages.

I. THE MORTGAGE AS INVESTMENT

An investor knows that availability of loans can depend on a number of things: the general business cycle, housing starts, local market conditions; or the interest rate environment, for example. The secondary mortgage market (FNMA and FHLMC) was designed to neutralize these problems by making loans available regardless of conditions. However, two major concerns must be dealt with: first, investors can't always realize the minimum yield they require from secondary market sources; and, second, must choose from products which may or may not suit them.

A. LONG TERM, FIXED RATE LOANS

Another dilemma centers around fixed versus adjustable rate lending. Nearly all investors prefer loans sensitive to their cost of funds. The problem has been finding an alternative to fixed rate instruments that consumers will accept.

It appears that fixed rate loans are most in demand when rates are at thirteen percent or lower. Just two years ago this shelf was at twelve percent. But fixed rate lending offers the least hedge against inflation from the investor's viewpoint. The record shows that borrowers will opt for ARM's provided enough choices are available.

1. There are four ways long term, fixed rate lending can survive:

   (a) Lenders may continue to offer these terms but will build larger inflationary hedges into their rates.
   (b) Borrowers obtain rate subsidy from sellers or public agencies.
   (c) Shortened amortization. Establishing loan term was largely a regulatory matter in the past.
   (d) Long term amortization with call options. This is very close to the terms of a seven or ten year ARM.

Extending the term to 35 or 40 years fails to lower monthly payments sufficiently and impedes recapture of principal in a timely fashion.

B. ADJUSTABLE RATE LOAN PRODUCTS

The entire investment community is working to design a universally accepted ARM instrument but, as we shall see, it is improbable a plan will surface within the immediate future. There are two principal reasons for this. First, consumer demand tells us that borrowers need the ability to modify or amend parts of an ARM loan to accommodate their needs. This makes standardization difficult. The second reason involves how loans are sold. Emphasis is being placed on collateralization of mortgages rather than whole loan sales as in the past.

C. OTHER INVESTOR CONSIDERATIONS

There are other difficulties investors experience with mortgages: whole loans are not as liquid as other investments; portfolio management is costlier than, for example, bonds; average loan amounts are comparatively small; regulatory compliance is expensive; and finally, local thrifts tend to hold the paper on most high quality property resulting in lower quality investor portfolios.

II. MORTGAGE LOAN ORIGINATION TODAY

Not only are loan products undergoing change, the very manner in which mortgage loans are made is changing. The industry has seen a blurring of lender roles. Today's borrower is faced with choosing between increasing numbers of companies willing to help arrange mortgage financing. And the offer to help is sounding more like the canned pitch of the Veg-o-Matic sales corps.

A. NEW ENTRANTS TO LENDING

Few conglomerates haven't at least looked at mortgage banking as subsidiary activity. Today you can find retailers, builders, aircraft manufacturers, automobile makers, mortgage insurers and title companies all in the mortgage business. Since volume is the key to their profits, emphasis is on closing loans that can be immediately sold into the secondary markets.

This system worked for years in a fixed rate environment, allowing lenders to compete on the basis of rate, term and fees. Whether it will continue to work in favor of consumers remains to be seen. It is unclear whether borrowers, after having found a home for $150,000 will want to walk through a drygoods department to apply for a $120,000 mortgage in a retail store setting.

B. HOW AUTOMATION CHANGES THE LENDER'S ROLE

In August of 1983, the Department of Housing and Urban Development issued a Mortgagee Letter allowing the payment of a fee to certain real estate brokers who assist in the application phase of FHA loans. The justification for this was that any computer-assisted plan which benefits the consumer ultimately reduces cost. This brought the real estate broker into the lending picture officially for the first time.

Various informational computer programs are now available for both lenders and brokers. One national lender is experimenting with paying the real estate sales person for taking a loan application and at least pre-qualifying the prospect.

This kind of change places the investor further from the loan applicant and could have disastrous results. At one point, FNMA and FHA both required a face-to-face interview with applicants in an effort to avoid fraud and improve the quality of information lenders receive.

III. CHOOSING A LENDER

A. THREE ESSENTIAL QUESTIONS TO ASK

There are three essential questions every borrower should ask of potential lenders:

1. What kind of local commitment does this lender have?

   Big companies like to talk about their national conduit - a network of storefront offices in or near good loan markets where they either originate or buy loans. Chances are they will have a sales staff paid on a commission basis. You may apply and close the loan at the branch office, but loan payments are made to their main office (servicing).

   If business drops off or quotas aren't met, the office can be closed and you will have to deal with someone in a distant city. Keep in mind that decisions about your loan are made wherever the main office is. The primary job of the branch is to gain a share of the local mortgage market.

2. Is the lender the investor?

Nothing replaces the ability to speak directly with the holder of your mortgage. If your lender acts merely as a loan broker you will be subject to administrative and interpretive rulings of the company that owns your mortgage. This is true regardless of what a sales person tells you.

Final decisions are always made by the investor. During times of economic distress it can be difficult to adequately portray your circumstance to someone thousands of miles from your home.

3. Can the lender modify the agreement?

If meeting your special needs will make the loan considerably better for you, find out if the lender can make those decisions and modifications for you.

Reserve accounts are a good example. Some lenders allow the borrower to maintain a savings account for purposes of paying taxes and insurance premiums. Private mortgage insurance is another example. Not all lenders require this expensive coverage on loans exceeding 80% of value. Some self-insure. And if there is an increase in interest rate it is tax deductible. Mortgage insurance premiums are not.

B. LENDER CLASSIFICATIONS

A lender's status is important in dealings long after the loan is closed. Your contact is likely to include questions about payments not reaching the lender on time, reserve account balances, annual statements, questions about assumability and a host of other details.

Lender status may also dictate the manner and extent to which you are informed as to the terms of a loan you are considering. Lenders subject to a high degree of government control and audit tend to be scrupulous in their disclosures of rates and terms.

1. Organized institutions

Banks, savings banks, savings associations, credit unions, bank holding companies and their subsidiaries are generally considered supervised lenders. This definition is allowed only if an agency of the federal government regularly audits its books and records. You may expect compliance with disclosure laws and routine dealings to be very much in order.

This class of lender generally maintains strong loan policy, publishes rate and fee schedules, issues written loan commitments and is usually reliable. Most regard their customer relationship highly and for this reason are a good place to start for mortgage financing.

2. Mortgage companies

Mortgage companies are supervised or unsupervised, again depending on government audit. Having HUD or FNMA approval would not automatically attach greater status (such approval is relatively easy to obtain). Some are members of their national organization (The Mortgage Bankers Association), maintain credit lines with local banks, and subscribe to a code of ethics.

Companies not considered supervised fall under jurisdiction of the Federal Trade Commission (FTC). Mortgage companies are volume driven and nearly all will have commissioned sales people.

IV. DISPELLING MYTHS OF THE PAST

A. NO ONE HAS EVER LOST BUYING PROPERTY.

While inflation has made this largely true, buyers today are motivated as much by need for shelter as by appreciating value.

B. ALWAYS LEVERAGE UP.

It made sense to borrow the most when fixed rates were held artificially low since you were repaying with inflated dollars. Today this is no longer true. To keep the overall cost of borrowing down, it can make more sense to put as much down as possible.

C. FIXED RATES ARE BEST BECAUSE I'LL ALWAYS KNOW WHAT MY PAYMENTS WILL BE.

Those who insist on fixed rate, level payment loans may be paying a heavy penalty. Investors will hedge long term fixed rates even more than in the past because of inflation uncertainty.

D. YOU SHOULDN'T SPEND MORE THAN 25 TO 28% OF YOUR MONTHLY GROSS INCOME FOR HOUSING.

Lenders are recognizing that buyers are willing to commit greater percentages of their income to housing. The truth is that stability and liquidity are becoming more important in underwriting single family homes.

E. AFTER ALL, THE LENDER WILL SEE TO IT THAT I DON'T GET IN OVER MY HEAD.

There are too many volume-driven lenders to expect anything beyond legally mandated disclosures. If you suspect that you won't be able to make payments don't rely on the lender to reject your application.

V. THE ADJUSTABLE RATE ALTERNATIVE

The future may see ARM loans gaining a greater share of the mortgage market. While private mortgage insurers are quick to point to overall ARM foreclosures, the reasons are scattered and no clear trend is yet apparent.

This may not alleviate all consumer fear but as new programs are added, buyers will quickly learn it is possible to do as well or better with adjustable rates than with fixed. An example of this is found at Appendix A.

A. When compared with fixed rate instruments, adjustable rate loans contain certain advantages:

1. LOWER INITIAL RATE

ARM loans nearly always offer an interest rate break during the initial period. Such strategy not only helps qualify more buyers, it allows greater loan amounts. This self imposed reduction is designed to make ARM loans more attractive but can result in payment increases too large to handle.

Buyers are qualified on the initial rate. When the loan reaches its first adjustment, the fully indexed rate applies. This could translate to unmanageable payment and is one criticism of the feature.

If ARM lending proves vulnerable to first adjustment delinquency, lenders may qualify buyers on the fully indexed rate. Until then, teaser rates are clearly useful and a benefit to many buyers.

2. AUTOMATIC PAYMENT REDUCTION WHEN RATES FALL

If there is any chance of rates softening, adjustable products provide immediate benefit since borrowers don't have to refinance to enjoy lower payments. The adjustable feature translates rate reduction to payment reduction.

3. HIGHER LOAN LIMITS

Loan maximums are a way to control credit. Statutory loan ceilings have generally followed property values up over the years. But two things have occurred that will force a change in this pattern: A clear investor preference for rate sensitive loans and thundering demand for profit.

In view of this, there is every reason to believe that the secondary market will raise ARM loan limits while leaving fixed rate ceilings untouched. This would encourage rate sensitive borrowing and improve portfolio performance.

4. ASSUMABILITY

Generally, adjustable rate loans are assumable subject to creditworthiness. This advantage will increase over time since investors are more and more reluctant to hold fixed rates for long term without some assurance of rate call.

Creditworthiness has two elements in a real estate transaction: terms of the sale; and the borrower's ability to handle payments and payment increases.

If assumability is important to you, a careful review of the loan documents is in order. Some plans allow assumption one time only, others have no restriction on the number of times assumption may occur, subject to creditworthiness.

5. PERIODIC CASH INFUSION

Many people are paid bonuses, commissions, overrides, or are on company profit sharing. This can result in periodic discretionary income. If this money is applied to principal reduction immediately prior to an adjustment, payment reduction is possible.

This would not be the case with a fixed rate loan since the amortization schedule calls for equal installments. Additional cash payments to a fixed rate amortized loan simply shorten its term. Few lenders are willing to recast payments on amortized loans since it may result in technical violation of regulations.

6. MARGIN BUYOUTS

Permanent or temporary buydowns of the interest rate are simply short or long term subsidy. Buydown plans are a common and frequently used marketing device.

ARM's can contain an initial rate, an accrual rate (negative amortization is scheduled), and an indexed rate (the index plus a margin). The margin is a yield hedge. Investors want to assure a minimum return.

But the same is true on fixed rate loans, and permanent buydowns are always possible. Some lenders will allow an ARM borrower to buy the margin out. This is roughly equivalent to a permanent buydown on a fixed rate loan. The difference is that the investor is willing to live with the index rate.

This becomes a floating rate ARM and could result in a lower overall cost of funds than a fixed rate loan. But not all lenders offer the option and of those that do, not all ARM loans qualify for this feature.

VI. HOW ADJUSTABLE RATE LOANS THREATEN MORTGAGE LENDING

A. THE 95% CONVENTIONAL ARM LOAN

Some are predicting the demise of this loan. Mortgage insurers report adverse claims experience and question their ability to continue underwriting the risk. This represents significant threat to the flow of credit to housing.

Property appreciation rates aren't keeping up with the 95% buyer who finds himself in trouble. This borrower is ten times more likely to allow the property to go back to the lender for lack of equity.

In this type of loan sellers are often putting as much into financing concessions as the buyer is putting in down payment.

B. A NEW KIND OF PROPERTY VALUE MAY EMERGE

Seller participation in mortgage financing is causing some to question whether property valuation shouldn't reflect actual dollar contributions. Arguably, sellers accept less for their property when paying concessions for homebuyers.

Appraisers are meeting with trade associations in an attempt to redefine Fair Market Value. Secondary market sources are encouraging lenders to measure a property's sale price against Fair Market Value and Cash Equivalent Value.

Cash Equivalent Value would accommodate concessions made by anxious sellers and, some argue, reflect more accurately how a lender will come out in event of foreclosure. Current thinking is to have lenders use Cash Equivalency as their lending base. Thus, a property selling for $90,000 would not automatically qualify for financing based on this sale price.

Suppose the seller paid four points (4%) to help the buyer secure a loan. This is equivalent to selling the property for $86,400 ($90,000 minus $3,600) and the loan amount should be based on this amount.

If the market value of this property was $90,000, the buyer, putting 10% down (or $9,000), would routinely apply for a loan of $81,000. Using cash equivalency as a yardstick, the loan would be based on Cash Equivalent Value of $86,400 and the loan amount would be reduced to 90% of that figure, or $77,760.

This would require a cash downpayment of $12,240, or 14% of the sale price. There would be no advantage for the seller to offer the incentive.

At this writing, the industry is attempting to resolve the issue by calling for a redefinition of Fair Market Value to include financing concessions of the subject property as well as any comparable properties used in the appraisal process. FNMA has softened its position in recent weeks but is still calling for a resolution of the problem.

VII. MOVABLE PARTS OF AN ARM LOAN

A. THE LOAN COMMITMENT

Begin by insisting your lender provide a written commitment to make the loan on the terms you request. Without this, you have nothing more than an offer to do business - which is going to be changed the moment the money market moves in favor of the lender.

When you apply for a mortgage, the lender expects a written application from you, then orders a written credit report and written verification of employment and deposit to prove your validity. Not to expect a written commitment subjects you to the possibility the lender may change the terms at closing.

B. INTEREST RATE TREATMENT

Rate consideration begins with the index used to adjust payments. Few lenders allow choice of index as part of their program. The Federal Home Loan Bank (FHLB) Cost of Funds and Treasury Bill Indexes are widely used.

T-Bill Indexes are routinely published and represent a good measure of the cost of money, although many consider the six month T-Bill Index too volatile to be useful in mortgage lending. Composites of Treasury Bill offerings also provide good yardsticks to the average cost of funds.

The FHLB Cost of Funds is a compilation of the cost of money from one institutional group - primarily mortgage lenders. But there is a lag in reporting which may result in adjustments out of cycle with the economy.

C. RATE CAPS

ARM lending is a shared risk arrangement. The lender is attempting to limit the burden of rising rates. To mitigate the effect of rising rates the borrower can ask for an annual rate cap (the rate will never exceed ___% within any given year) and/or a lifetime rate cap (regardless of how the index behaves, the rate will never exceed ___%).

Lifetime rate caps are recommended. But look carefully. Some lenders will place a floor (or minimum) rate on loans with lifetime caps. Regardless of how low the index falls, interest will not fall below this floor rate. Others are willing to stay with the index chosen and follow it.

Annual caps can be established in two ways: a maximum increase beyond the initial rate or the fully indexed rate. The difference can be significant since initial rates are cast artificially low. Try to cap beyond initial rates.

D. PAYMENT CAPS

The peril of payment caps is that they may trigger negative amortization. If a capped payment is insufficient to cover required amortization, the agreement may call for accrual of interest. Such unpaid interest is added to the outstanding principal.

This is more likely to occur in the early years of a mortgage when loan balance and value are close. The result could be equity erosion. As the loan is paid down, payment caps become less threatening so they may be advantageous and a good feature to have.

Some FNMA plans have optional payment caps, which is having the best of both worlds.

E. NEGATIVE AMORTIZATION

Negative amortization works against the borrower in two important ways: first, it results in paying interest upon interest, and second, it can result in rapid loss of equity. Some lenders simply don't allow negative amortization.

It is such a doubtful idea that lenders themselves limit its use. Any plan providing such will not allow the principal to exceed 125% of the original loan amount. If it does, the borrower must accept the increased payment over the remaining term so that the loan is paid off within its original term.

Some loans have scheduled negative amortization. The borrower knows in advance how high the principal will rise. These graduated payment mortgages were an early alternative to high rate, level payment loans.

Acceptance of increases in payments as they occur is seen as a better alternative than the greater overall cost and possible loss of equity.

F. CONVERTIBILITY AND REFINANCING

Good ARM loans contain a provision to convert to fixed rate instruments at some time in the future. This may be limited to the first 24 or 36 months. Having the option is important and could save money in new loan fees.

This feature allows the borrower to literally play the money market against the lender. Should fixed rates fall to palatable levels during the convertible time limit, the borrower simply notifies the lender of his election to turn the loan into a fixed rate mortgage. This is accomplished through amendments to the original agreement.

The agreement will specify the fixed rate to be used on conversion, usually higher than current fixed rates. Often this is the FNMA mandatory 60 day delivery fixed rate. Lenders don't want to encourage fixed rate borrowing.

Lenders not offering this device will quickly point out that borrowers need merely refinance the ARM loan should fixed rates drop to attractive levels. After all, they argue, there is no prepayment penalty. But refinancing is costly and the borrower may have to requalify under stricter standards.

G. FEES

Loan fees rarely cover origination costs. Today, loan fees may include factors to cover initial rate breaks or even future interest. Few lenders will give you a statement that fees, or any portion, cover prepaid interest, but if it can be shown that any part of an up front fee was applied to interest it stands a good chance of being tax deductible.

The only way to know for certain is to have a tax specialist advise you. Sometimes published rates and fees demonstrate that the increased charge reduces the note rate, as in this example:

5 YEAR ADJUSTMENT		7 YEAR ADJUSTMENT	
RATE	FEE	RATE	FEE
13.500	0.000	13.625	0.000
13.250	1.000	13.375	1.000
13.000	2.000	13.125	2.000
12.750	3.000	12.875	3.000
12.500	4.000	12.625	4.000
12.250	5.000	12.375	5.000
12.000	6.000	12.125	6.000

VIII. AN ADJUSTABLE RATE CHECKLIST

The loan that comes closest to meeting the borrower's needs is the best possible loan. Since mortgage loan components are more negotiable now than at any time in the past, buyers have the greatest opportunity ever to custom design terms that will accommodate their needs.

A. THREE QUESTIONS EVERY BUYER SHOULD ASK:

1. How long will I own this home?

If it certain you will transfer to another city within three or five years, an adjustable rate loan provides early-years low interest benefits. In this case, it probably makes sense to leverage as much debt as possible since you may sell on the basis of an assumption.

If you plan on long term ownership, you can hold the cost of borrowing down by borrowing as little as you can. Margin and rate buydowns become more important in negotiating with your seller.

2. How fast will my income rise in the next five years?

   Lenders try to anticipate just this sort of thing. Few people expect their income to shrink in the years ahead, but have trouble measuring potential increases. Figures show that the average annual wage increase of American workers is about seven and a half percent.

   If you expect inflation to run between three and five percent and that your company will follow national trends in wage increases, it's fairly safe to count on additional income sufficient to cover payment increases. But you may want to limit your risk by insisting on annual caps.

3. Am I a good money manager?

   Whether or not you are able to anticipate expenditures seems to be one key in good personal money management. If you can discipline spending to accommodate the future you should have little trouble managing an adjustable rate loan.

B. RECOMMENDED INGREDIENTS TO YOUR ADJUSTABLE RATE LOAN

1. A WRITTEN LOAN COMMITMENT

Obtain a written loan commitment from the investor specifying exact terms agreed upon. There should be an expiration date beyond which new terms would have to be arranged. Allow enough time for processing the loan and obtaining necessary documents.

2. ACCEPTABLE INDEXES

Treasury Bill Indexes are published regularly and are easily available. T-Bill Composites are acceptable. The important thing is that these indices are out of the control of the investor.

3. MARGINS

If your loan is sold into the secondary market it will help to know that FNMA has minimum required margins which include .50% for the investor to service the loan. For example, on 1 year ARM loans the margin is 1.50%. The lender originating the loan gets to keep anything over 1.00%.

Margins may or may not be negotiable depending on the type of lending institution. Margins may increase when "insurance" in the form of lifetime caps or payment adjustment caps are added.

4. NEGATIVE AMORTIZATION

Choose a plan without negative amortization. Uncertainty in the rate of property appreciation makes this element unattractive.

5. RATE CAPS

Annual and Lifetime interest rate caps are recommended. Caps apply to adjustment periods. A 5 year adjustable loan will adjust each 60 month period. You can cap that adjustment as well as applying a lifetime cap.

Make sure adjustment caps do not exceed 1% per annum. Caps that exceed 1% per annum can result in unmanageable payment increases of over 7 1/2% per year.

Rate increases occurring during the first adjustment period are the greatest hazard, therefore the best plan will have a maximum annual rate increase from the initial interest rate not exceeding 1%.

6. PAYMENT CAPS

Payment caps are not recommended since they introduce potential for negative amortization. The target to shoot for is maximum annual rate adjustments that result in payment increases not exceeding 7 to 8%.

7. CONVERTIBILITY

For an additional fee, the lender may allow a conversion option. Within a specified time you may convert the ARM loan into a fixed rate amortizing mortgage. This feature allows the borrower to take advantage of a soft interest rate market without having to refinance. Ask for a comparison between the current fixed rate and the rate the lender would allow if your ARM loan were converting today. This will give you an idea of how conversions are priced.

The conversion is accomplished by modifying the original documents, saving time and money. Additionally, the borrower does not have to requalify.

8. ASSUMABILITY

The loan should be assumable subject only to creditworthiness. There should be no limit as to the number of assumptions allowed.

9. GRADUATED PAYMENT MORTGAGE

GPM's or combinations of GPM's and GP ARM's are not recommended because of their potential for negative amortization.

10. ADJUSTMENT FREQUENCY

The record seems to indicate that plans which adjust payments and/or rates more frequently than once a year are generally unfavorable to borrowers. These often involve interest rate accrual.

11. BUYDOWNS

Use rate and/or margin buydowns wherever possible. Use greater care in negotiating value when seller concessions approach 5% of the sale price. This may signal appraisal difficulty.

IX. SUMMARY

The forces at work affecting mortgage credit shift dramatically over time. Housing is closely tied to national politics and is often the sector used to absorb wide swings in credit availability.

Lenders must find a way to meet the needs of housing within this uncertain environment. In the final analysis, it is the government that determines how much credit is available, when it will be available, and at what cost.

APPENDIX A

ONE YEAR ADJUSTABLE RATE MORTGAGE

T-BILL INDEXED

20% Annual Cap, 5% Lifetime Cap, 0% Margin (buyout), No Payment Caps, No Negative Amortization. Initial Rate is 9.75%. Loan Amount is $80,000; Term is 30 years; assume a 2% increase in the Index each year.

Comparison of the first five years of performance with a 13.00% fixed rate conventional mortgage loan.

YEAR	INDEX	RATE
1	9.30	9.75
2	11.30	11.75
3	13.30	13.75
4	15.30	14.75
5	17.30	14.75

The average rate paid by the borrower is the sum of rates shown in the rate column (64.75) divided by five, or 12.95%

YEAR	FIXED RATE	ADJ. RATE	% CHANGE	$ CHANGE
1	884.96	687.32	0%	0.00
2	884.96	805.89	17% +	118.57
3	884.96	927.53	15% +	121.64
4	884.96	989.06	7% +	61.53
5	884.96	989.06	0%	0.00

The total amount paid in interest is less on the ARM plan. However, increases in payments come in the crucial years of the loan. From the standpoint of keeping total cost down, the ARM outperforms the fixed rate loan in this example.

Consumers
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RESPONSE TO WRITTEN QUESTION OF SENATOR GARN
FROM
MICHELLE MEIER

1. Do ARM issuers adequately consider a borrower's future credit worthiness since his income may remain constant in the face of significant increases in his mortgage costs?

ARM issuers do not adequately consider a borrower's future credit worthiness. Most lenders qualify ARM borrowers solely on the basis of the initial interest rate using the same qualification criteria that are applied to fixed rate mortgages.

Thus, the industry claims that ARMS provide mortgages to persons who otherwise would not qualify for a fixed-rate loan. The other side to this claim, however, is that these same borrowers will not be able to handle significant increases in mortgage costs, which many ARMS allow, and will go into default in the face of such increases. It has only been because interest rates have been on a downward trend since ARMS became a significant presence in the mortgage market that a large number of defaults and delinquencies on ARMS have not yet occurred.

Yours truly,

Michelle Meier
Counsel for Government Affairs